

metrowerks inc.
1997 annual report

AR58

You're
gonna
make
this
little
guy

CodeWarrior for PalmPilot®

You're revved up. You're ready to write code for the PalmPilot. Introducing Metrowerks CodeWarrior for PalmPilot. Just \$369. Proof positive that size doesn't count. It's a small price to pay for big, industrial-strength tools. They're new and improved, with the features you need to create your killer app:

CodeWarrior C hosted on Windows 95/NT and Mac OS

Constructor for PalmPilot (our new drag-and-drop visual interface builder for PalmPilot applications)

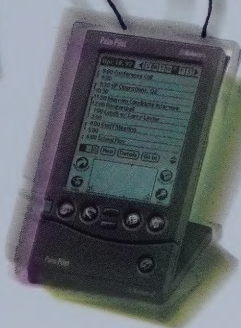
Support for Palm OS 1.0 and Palm OS 2.0 (when available)

New direct-to-device debugger for Motorola's MC68328 Dragonball processor

Buy now and we'll send you our new Windows 95/NT desktop programming tools free* of charge.

The little PalmPilot is this year's biggest hit. Make your application the next. All you need is a big idea and a little help from CodeWarrior.

PalmPilot




CodeWarrior for PalmPilot. Make it big.



You're gonna make this little guy

SCREAM



CodeWarrior for PalmPilot

You're used to having to write code for the PalmPilot. Introducing PalmOS Developer for PalmPilot. Just \$349.95. Almost everything that other developers know, it's all built in to the PDC for Palm. Independent-Developers Tools. You're now even improved, with the features you need to create your better app.

CodeWarrior is hosted on Windows, Mac OS, and Mac OS.

CodeWarrior for PalmPilot is our new and most advanced interface to the PalmPilot. PalmPilot Developer's Tools. Includes the Palm OS 3.5 ROM.

Run OS 3.5, when available.

Go direct to the low on developer.


Use the PalmPilot's Windows program!

It's done.

Our new and we'll send you our new Windows PDC! Startup programming tools free of charge.

The little PalmPilot is this year's biggest hit. Now your software can meet. All you need is a big new one in little help from CodeWarrior.

PalmPilot



CodeWarrior for PalmPilot. Make it big.

CODE WARRIOR


EMBEDDED SYSTEMS

CodeWarrior
Embedded Systems

Over 100,000 registered developers in 15 countries have been killing bugs and writing code for 10 years with our tools. Now you can too. Whether you're programming for a proprietary embedded system, like IBM PowerPC, or for an off-the-shelf MCU, like Dallas or 68010. We take powerful, fully-featured tools to the extreme.

The award-winning CodeWarrior IDE
Project manager with IDE
Integrated compiler
Assembler
Supports all embedded processors, debugger
Supports for C/C++/C51 and C51 compiler
C51, C++ and assembler debugger

For more information call 800-828-6228
or visit our web page for yourself.


mentorgraphics

METROWERKS ENTERED THE EMBEDDED SYSTEMS MARKET IN 1997.

ON THE FRONT COVER IS A REPRINT OF AN ADVERTISEMENT PLACED IN "PC WEEK" AND "COMPUTER RESELLER NEWS" IN JUNE AND JULY 1997. THE ADVERTISEMENT LAUNCHED THE NEW VERSION OF CODEWARRIOR FOR PALMPILOT.

THE BACK COVER IS A REPRINT OF AN ADVERTISEMENT PLACED IN THE SEPTEMBER, OCTOBER, AND NOVEMBER ISSUES OF "EMBEDDED SYSTEMS PROGRAMMING" TO LAUNCH CODEWARRIOR FOR POWERPC EMBEDDED SYSTEMS.

LETTER FROM MANAGEMENT

Welcome to Metrowerks Inc.'s ("Metrowerks" or "the Company") report to its shareholders for the fiscal year ended July 31, 1997 ("FYJuly97"). This is our fourth annual report as a public company, and we hope it is helpful to our shareholders in understanding the software development tools business and Metrowerks' place in it. In particular, we would like to welcome all of our new shareholders who purchased Metrowerks common shares in the past year.

Metrowerks designs, develops, markets and supports professional software development tools used by programmers to create software applications. Our flagship product line, Metrowerks® CodeWarrior®, consists of a suite of programming tools used by developers worldwide to create software in the C, C++, Java,™ Pascal and low-level (assembly) programming languages. These languages are the most powerful languages available and are designed to accomplish the most difficult programming tasks. CodeWarrior has more than 100,000 registered users in 75 countries.

The key to success for any technology company is the people who make it happen. We have a fantastic group of people who share one vision: to bring to market the best programming tools in the world. Our employees have changed the industry by extending the CodeWarrior Integrated Development Environment ("IDE") and development tools to support a wide variety of desktop and embedded systems platforms. Their incredible hard work has enabled Metrowerks to transition itself into a major multi-language, multi-platform programming tools vendor in a very short period of time. We now employ 180 people, with more than 100 employees in research and development, with offices in Austin, Silicon Valley, Montreal, Tokyo, and now Boston.

When we started the CodeWarrior project in 1991, our long-term goal was to build a large, profitable software company. To do this, we knew we would have to develop tools beyond our first product, CodeWarrior for Macintosh.® Launched in 1994, CodeWarrior for Macintosh has been a runaway success, garnering a worldwide market share of over 75 percent. During FYJuly97, CodeWarrior's only serious Mac®-based competitor, Symantec C++ for Macintosh, was put in maintenance mode, and no future major upgrades are scheduled for this competing product. While we now dominate the Macintosh tools business, Apple Computer's problems in the past year have made for extremely difficult market conditions. In Q3FYJuly97, Metrowerks experienced a serious decline in Macintosh sales and, as a result, we recorded a non-recurring charge of US\$4.3 million, details of which are included in the Company's Form 10-K which follows.

In FYJuly97, we invested 35 percent of our overall revenues in research and development, one of the highest such investment rates in the software development tools business. We are now developing and selling programming tools in four major market segments: the desktop Windows® and Macintosh market, the embedded proprietary operating systems market, the real-time operating systems ("RTOS")/Windows® CE market and the Java technology market.

At the recent Embedded Systems Conference West/1997 in San Jose, Metrowerks announced significantly increased CodeWarrior support for embedded software development, with over 20 press announcements covering all aspects of the embedded software development tools market.

Emphasized in our announcements was the CodeWarrior solution for embedded programmers, which is comprised of two key components:

1. The CodeWarrior IDE, which is a totally integrated development environment common to all CodeWarrior embedded and desktop products. The CodeWarrior IDE contains a complete set of programming tools, including class browsers, editors, a state-of-the-art project manager which obsoletes "make" files, two-machine debuggers which support both source-level and assembly-level debugging, and debug formats that include DWARF (Debug With Arbitrary Record Format), Motorola S-Records, Background Debug Mode ("BDM"), and Joint Test Action Group ("JTAG").
2. CodeWarrior's highly optimizing C, C++, Java and Pascal compilers feature support for a variety of microprocessors, including 68K, PowerPC®, x86 and MIPS®. The CodeWarrior compilers, linkers and debuggers support a variety of proprietary operating system object formats as well as industry standard formats such as Executable Linkable Formats ("ELF") and Microsoft Common Object File Format ("COFF").

In particular, Metrowerks announced tools for additional microprocessors, new CodeWarrior releases for the proprietary operating systems already supported, support for new real-time operating systems, planned support for Windows CE 2.0, and a number of additional selling and marketing arrangements with other embedded tools vendors.

Additional CodeWarrior Microprocessor Support:

Advanced RISC Machines ("ARM™") - Metrowerks announced that it will support a new family of microprocessors, the ARM architecture tuned for architecture 3 and 4, including the 7500E, the StrongARM™, and THUMB™-enhanced ARM architectures. CodeWarrior for ARM will be available in the second quarter of calendar 1998. CodeWarrior for ARM Embedded Systems will retail for US\$899.

Hitachi SuperH™ ("SH") - Metrowerks announced that it will support a new family of microprocessors, the Hitachi SuperH architecture. CodeWarrior for SuperH Embedded Systems will be available in the second quarter of calendar 1998. CodeWarrior for SuperH Embedded Systems will retail for US\$899.

MIPS16 - Metrowerks announced that it will support the new MIPS16 compressed Reduced Instruction Set Computer ("RISC") instruction set extensions to the MIPS instruction set. The MIPS16 extensions allow for development of applications with smaller memory footprints. CodeWarrior MIPS16-enabled compilers will be available in the second quarter of calendar 1998. CodeWarrior for MIPS16 will be incorporated into CodeWarrior for MIPS Embedded Systems which will retail for US\$899.

MIPS - Metrowerks will be shipping in October 1997 CodeWarrior for MIPS Embedded Systems with support for MIPS ISA levels I & II. CodeWarrior for MIPS will retail for US\$899.

NEC - Metrowerks will provide full support for the NEC VR4100, VR4300 and VR5000 MIPS-based microprocessors (ISA levels I, II, III and IV). The first release of CodeWarrior for NEC Embedded Systems will ship in the first quarter of calendar 1998, and support for the NEC V830™ and NEC V831™ microprocessors will be included in future releases. CodeWarrior for NEC Embedded Systems will retail for US\$899.

PowerPC - Metrowerks will be shipping its second release of CodeWarrior for PowerPC Embedded Systems, targeting Motorola's MPC821 and MPC860 PowerPC embedded processors, in October 1997. CodeWarrior for PowerPC Embedded Systems retails for US\$899.

Proprietary Operating System Market:

Sony® PlayStation™ - Metrowerks will begin shipping in October 1997 CodeWarrior for PlayStation Release 3, the latest version of CodeWarrior programming tools for developing games for the Sony PlayStation game console, and CodeWarrior for Net Yaroze, designed for hobbyist developers. CodeWarrior for PlayStation retails for US\$899 and CodeWarrior for Net Yaroze retails for US\$299.

RTOS/Windows CE Market:

Accelerated Technology Incorporated - Metrowerks has agreed with Accelerated Technology to build CodeWarrior support for the Nucleus™ real-time operating system. The first release will target PowerPC embedded microprocessors, with subsequent releases targeting other embedded microprocessors supported by Metrowerks. CodeWarrior for Nucleus on PowerPC will retail for US\$899.

Embedded Systems Products ("ESP") - Metrowerks has agreed with ESP to build CodeWarrior support for ESP's RTX™ and RTEK™ real-time operating systems. The first release will target PowerPC embedded microprocessors, with subsequent releases targeting other embedded microprocessors supported by Metrowerks. CodeWarrior for RTX/RTEK on PowerPC will retail for US\$899.

JMI Software Systems - Metrowerks has agreed with JMI Software Systems Inc. to build CodeWarrior support for JMI's C EXECUTIVE real-time operating system. The first release will target PowerPC embedded microprocessors, with subsequent releases targeting other embedded microprocessors supported by Metrowerks. CodeWarrior for C Exec on PowerPC will retail for US\$899.

ITRON™ - Metrowerks is joining the ITRON Technical Committee and establishing an ITRON porting lab in the United States. Metrowerks will also license MetroTRK to ITRON members.

Microware - Metrowerks will ship CodeWarrior support for the OS-9™ real-time operating system in October, 1997. The first release will target 68K and PowerPC embedded microprocessors, with subsequent releases targeting other embedded microprocessors supported by Metrowerks. CodeWarrior for OS-9 on 68K and PowerPC will retail for US\$899.

mented. We like to refer to them as markets of 10,000 niches. Programming tools vendors in the embedded market have not usually sold across many of the embedded niche markets because of a variety of different standards and technical discontinuities, and, primarily, because the investment capital has not been available to research and development teams large enough to span significant portions of the embedded tools market. As a result, of our ability to reuse core desktop technology, Metrowerks now has the largest research and development team of any embedded tools vendor in the embedded market. Embedded tools vendors that might challenge CodeWarrior in the marketplace have far fewer users than CodeWarrior has in the desktop market. Certainly the giant Windows market dwarfs all of the embedded market niches today. A direct result of this highly fragmented embedded marketplace is that embedded tools equivalent to CodeWarrior sell for at least ten times what CodeWarrior sells for on the desktop.

Because of our large installed base of users, Metrowerks is able to amortize the cost of the CodeWarrior IDE for desktop and embedded users over a larger number of programmers. We have gained technical economies of scale by being in the desktop and embedded markets. In addition, embedded systems hardware vendors are now trying to standardize on certain industry wide protocols such as ELF and DWARF to reduce the cost of supporting individual embedded hardware configurations. As a result of tremendous economies of scale and increasing standardization, we have priced our embedded tools at the unheard of low price of US\$899—thousands of dollars less than what other equivalent embedded programming tools sell for.


In the pages that follow, we hope to accomplish the following:

1. Describe in greater detail the markets in which we compete;
2. Explain how our engineers have designed our CodeWarrior products to meet these market opportunities;
3. Review our financial performance in FYJuly97.

We hope you enjoy this annual report. If you have any further questions about Metrowerks, please feel free to contact us at our e-mail addresses below, or call us anytime at 512-873-4700.

Your Management Team,

Berardino Baratta,	VP, Research & Development	baratta
Jean Bélanger,	Chairman & Chief Executive Officer	belanger
David Bowers,	Director, Program Management	dbowers
John Cheuck,	President, Metrowerks Co. Ltd.	john
Greg Galanos,	President & Chief Technology Officer	galanos
Dave Mark,	VP, Academic/Discover Products	dmark
Jenny Page,	Director, Marketing	page
David Perkins,	SVP, Sales & Business Development	perkins
James Walker,	VP, Operations	jwalker
Jim Welch,	VP, Finance & Chief Financial Officer	welch

 METROWERKS.COM

THE MARKET OPPORTUNITIES FACING METROWERKS

Metrowerks develops and sells programming tools that are sometimes referred to as "hard-core" programming tools. The market for software development tools can be segmented into two very distinct markets:

1. Hard-core tools, similar to those that Metrowerks develops and markets;
2. Database extraction tools, such as Visual Basic® and PowerBuilder®, which is a market Metrowerks does not directly participate in.

Hard-core tools are used to write software that uses the least amount of random access memory ("RAM") and executes user commands as fast as possible. Hard-core tools usually feature any one of four widely-used languages: C, C++, Pascal or low-level (assembly) language. Increasingly, hard-core programmers are experimenting with Java.

The markets for hard-core programming tools can be characterized by where the software being developed will be deployed:

Desktop Market: Applications are built on a Windows 95, Windows NT, or Mac OS machine, to run on their respective platforms.

Proprietary OS Embedded Market: Applications are built on desktop computers or UNIX workstations and are downloaded or deployed on an embedded system running a proprietary or "single-use" operating system. An example of a proprietary operating system is the PlayStation OS, which was developed by Sony to run their PlayStation game console. In developing a proprietary operating system, hardware vendors start with an evaluation or reference board, which is usually designed by a microprocessor vendor to allow prospective clients to test their design running on a specific microprocessor. Metrowerks' proprietary OS customers purchase CodeWarrior to build their actual operating system on an evaluation or reference board, or they may use CodeWarrior to build applications to run on the finished system. Industry estimates vary, but the general consensus of opinion is that the proprietary OS market accounts for at least 50 percent of the overall embedded systems market, with the other 50 percent comprising the RTOS/Win CE market.

RTOS/Win CE Market: Applications are built on desktop computers or UNIX workstations and are downloaded or deployed on an embedded system running a real-time or "multi-purpose" operating system. RTOS and Windows CE are freely licensable for use by any embedded systems hardware vendor who is looking for an operating system and does not have the time or resources to develop a proprietary solution. Given volume considerations, it is often less expensive to license an RTOS or Windows CE, even after paying any run-time fees.

Java Technology Market: Java, the new programming language developed by Sun Microsystems, has taken the desktop by storm. Increasingly, embedded developers are also interested in deploying Java in their systems. Metrowerks has been actively involved with Microsoft in deploying Metrowerks' Java virtual machine ("VM") in Internet Explorer on Power PC and 68K. Metrowerks also deploys a full Java tools solution on Macintosh and Windows. Embedded microprocessor and RTOS vendors are licensing the Company's Java just-in-time or "JIT" compilers to accelerate Java applets running on their platforms. As mentioned above, at ESC West, we announced that we will be porting Metrowerks' Java tools and CodeWarrior IDE to run on Sun Microsystem's Solaris-based workstations.

The following table outlines the number of programmers in the world who use hard-core programming tools in these three markets:

Desktop:	Mac OS	100,000	4 %
	Windows	1,500,000	56
<hr/>			
Embedded Systems:	Total	1,050,000	40 %
<hr/>			
Total		2,650,000	100 %
<hr/>			

Source: Metrowerks Estimates, 1996 Dataquest Inc.

Needless-to-say, Metrowerks' entry into the embedded and Windows market dramatically increases the market opportunities available to the Company.

MAC OS MARKET

Since it was launched in 1994, CodeWarrior for Macintosh has been a runaway success, garnering a worldwide market share of over 75 percent. In FYJuly97, Symantec C++ for Macintosh, CodeWarrior's only serious Mac-based competition, was put in maintenance mode, and no future major upgrades are scheduled for this competing product. While we now dominate the Macintosh tools business, Apple Computer's problems over the past year have made for extremely difficult market conditions. In Q3FYJuly97, Metrowerks experienced a serious decline in Macintosh-based sales and, as a result, we recorded a non-recurring charge of US\$4.3 million, details of which are included in the Company's form 10-K which follows.

The Mac OS tools market is smaller than the embedded and Windows markets. However, it provides Metrowerks with the critical mass needed to move forward into these larger markets. No embedded programming tools companies in the world has as many registered users as Metrowerks. The Company's Macintosh users represent many of the world's finest programmers and, as such, Metrowerks is privileged to have access to their feedback on an ongoing basis. The Macintosh market has led the world in many areas, especially Graphical User Interface ("GUI") design. Metrowerks believes its fully GUI-based CodeWarrior IDE is one of its most important strategic competitive advantages as the Company moves into new markets, especially in the embedded systems market, where many programmers still use command-line tools.

Given the increasing importance of software in our economy, more and more people are interested in learning about programming. Traditionally, however, hard-core programming tools have been expensive and relatively inaccessible. As a result, in FYJuly96 the Company introduced an entry-level product line, Discover Programming.™ These products, priced under \$100, include CodeWarrior development tools, interactive learning aids and online books. Discover Programming products require modest investments in research and development because they use existing CodeWarrior tools. Discover Programming products are limited to developing non-commercial applications and do not effect sales of other CodeWarrior products. Given their success on the desktop, the Company has extended the Discover Programming line to Windows and intends to launch new Discover Programming products for certain embedded markets in FYJuly98.

EMBEDDED MARKET

Nothing illustrates the size of the embedded systems market better than the fact that over three billion embedded microprocessors, known as embedded microcontroller units, or "MCUs," were shipped in this market in 1996. By comparison, the entire computer industry consumed 250 million microprocessors, known as microprocessor units, or "MPUs." MPUs are almost all used in desktop, larger mid-range and mainframe computers.

Embedded MCU & Computer MPUs Shipped in 1996
(in millions)

	MCU		MPU	
	Units	Sales	Units	Sales
4-bit	1,070	\$ 1,410	—	\$ —
8-bit	1,863	5,560	40	140
16/32 bit	311	2,060	209	18,390
DSP	207	2,405	—	—
Total	3,451	\$ 11,435	249	\$ 18,530

Source: ICE

In the embedded systems market, Metrowerks is targeting the 32-bit MCU market, one of the fastest growing segments:

Worldwide Embedded MCU Shipments by Category
(in millions)

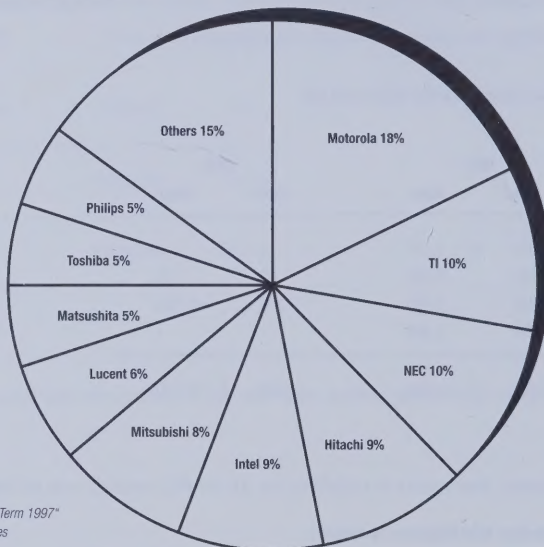
	'91	'92	'93	'94	'95	'96	'97 (est)
4-bit	906	979	1036	1089	1073	1070	1167
8-bit	753	843	1073	1373	1686	1863	2334
16/32 bit	39	46	60	120	184	311	333
DSP	24	34	52	77	123	207	333
Total	1722	1902	2221	2659	3066	3451	4167

Source: ICE

The bulk of the embedded systems market is comprised of 4/8-bit MCUs used in a variety of day-to-day devices such as VCRs, microwave ovens, etc. These 4/8-bit MCUs are usually programmed in assembly languages, and are therefore not target markets for Metrowerks. One of the most interesting developments in the microprocessor market has been the emergence of new, relatively low-cost digital signal processors (DSPs) that are powerful enough to process 3-D graphics, full-motion video, etc. Metrowerks continues to study this market because the new advanced DSP designs being produced today are programmable.

In contrast to the computer MPU market, where Intel is the dominant supplier, embedded MCUs are manufactured and sold by a variety of vendors:

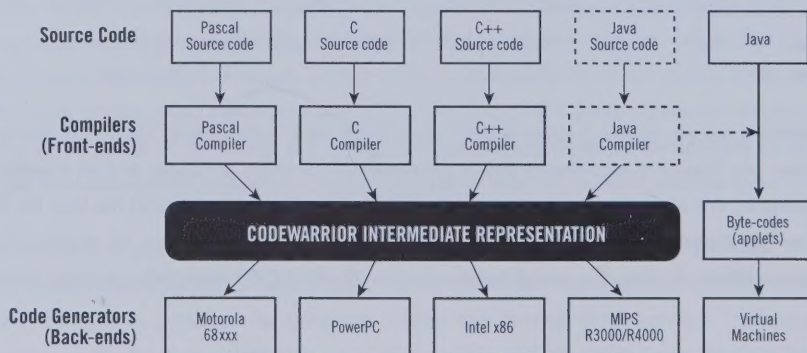
Leading MCU Suppliers* 1996 (est.) Market Share



Source: ICE, "Mid-Term 1997"
*Includes DSP Sales

Metrowerks believes one of its major competitive advantages in the embedded systems market is CodeWarrior's ability to support multiple microprocessors with relatively modest incremental investments in research and development. This is achieved by the innovative design of CodeWarrior development tools:

CodeWarrior Architecture



In addition to the microprocessors listed above, Metrowerks intends to provide code generators for the NEC VR/V8xx, ARM and Hitachi SuperH families of microprocessors in FYJuly98.

Once a programmer has finished writing an application, the CodeWarrior language front-end compiles the program listing (source code) into a CodeWarrior Intermediate Representation ("IR"). The CodeWarrior back-end code generator and optimizers convert the IR into executable code for a specific microprocessor and operating system (target platform).

CodeWarrior's architecture gives Metrowerks three competitive advantages:

1. Reduced research and development costs. If Metrowerks adds support for a specific MCU or MPU, only a new back-end code generator, linker and assembler need to be developed. The language front-ends do not have to be rewritten.
2. Rapid deployment. Given that a new language front-end does not have to be rewritten every time Metrowerks adds support for a new MCU or MPU, time-to-market is greatly reduced.
3. Code Coverage. Given that a new language front-end does not have to be rewritten every time Metrowerks adds support for a new MCU or MPU, the new MCU or MPU benefits from a tested, proven front-end language processor. Computer languages such as C++ are highly complex to implement and Metrowerks only has to implement each language once, thus obtaining greater code coverage and higher quality front-ends.

Given these advantages afforded by CodeWarrior's architecture, Metrowerks believes it is one of the lowest-cost providers of compiler technology for multiple MCUs and MPUs in the industry.

Metrowerks now supports several proprietary operating systems:

1. PalmPilot OS, developed by 3Com to run their new PalmPilot hand-held organizers using the Motorola 68328 MCU;
2. PlayStation OS, developed by Sony to run the Sony PlayStation game console using the MIPS R3000 MCU;
3. BeOS, developed by Be Inc. to run on computers running on PowerPC and Intel; and
4. Magic Cap OS, developed by General Magic for hand-held devices.

At ESC West, Metrowerks dramatically expanded announced support for the following real-time operating systems: C Exec OS, Nucleus OS, OS-9, Precise/MQX OS, RTXC OS, RTEK OS, and Tacit OS. These operating systems will be initially supported on PowerPC microprocessors (in the case of Tacit OS, the MC68328 Dragonball microprocessor). Subsequently, Metrowerks intends to support these operating systems on other microprocessors CodeWarrior supports. Metrowerks also announced that it will actively support the ITRON specification for ITRON-based operating systems, which are very popular in Japan. As indicated above, Metrowerks also announced at ESC West support for Windows CE 2.0. Metrowerks expects to ship CodeWarrior for Windows CE in Q3FYJuly98.

Metrowerks will continue to aggressively pursue the embedded systems market because the Company believes that it has significant competitive advantages in an overly fragmented market.

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PART I

Except for the historical information contained herein, the discussion in this Form 10-K contains forward-looking statements that involve risks and uncertainties. The Company's actual results could differ materially from those discussed here. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below, as well as under the captions "Additional Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

ITEM 1. Business

Metrowerks Inc. ("Metrowerks" or "the Company") was amalgamated on January 1, 1990 under the Canada Business Corporations Act and the information contained herein includes that of the Company and its two wholly-owned subsidiaries, Metrowerks Corporation, a Texas corporation, which was formed in June 1994, and Metrowerks Co. Ltd., a Japanese corporation, which was formed in October 1996. Metrowerks is a computer software development company that designs, develops, markets and supports software programming tools. The Company's products are used primarily by professional software programmers and by programmers in the academic community to create software applications. The Company's principal product line, Metrowerks® CodeWarrior®, consists of a suite of programming tools used to develop software in the C, C++, Pascal, Java™ and Assembly programming languages.

CodeWarrior is hosted on the Windows® 95 and Windows NT®-based and Macintosh® computers and is used to develop software for platforms using a variety of operating systems ("OS") including desktop operating systems Windows 95 and Windows NT and Mac® OS, Real-Time embedded Operating Systems ("RTOS") such as Nucleus OS™, OS-9™, Precise/MQX OS™ and Tacit OS™, and proprietary embedded operating systems such as PlayStation™ OS and Palm OS™.

The Company's principal line of products, known as CodeWarrior, includes an Integrated Development Environment ("IDE") which includes: native and two-machine debuggers, which use a common user interface and which provide source-level debugging capabilities for a variety of operating systems, including those listed above; a text editor for editing source code; class browsers used for developing and editing programs in object-oriented languages such as C++ and Java; a state-of-the-art project manager which obsoletes "make" files; computer language compilers for compiling source code written in C, C++, Pascal, Java, and assembly programming languages into machine code for a variety of microprocessors, including the 68K, PowerPC®, x86, and MIPS® families of microprocessors; and linkers, which permit compiled object code to be linked to create "executable object code," or what is known as software programs.

The Company believes that CodeWarrior has become the industry standard for developing Macintosh programs, and that its CodeWarrior products have been used to program over 75% of all software applications that run native on the Power Macintosh™ computer. Since the introduction of the CodeWarrior in January 1994, the number of registered users of CodeWarrior has grown to over 100,000 users in 75 countries.

BACKGROUND

PROGRAMMING LANGUAGES AND COMPILERS

Microprocessors operate based on electrical impulses, with each character or "bit" consisting of "on" (current or "1") and "off" (no current or "0"). Each keystroke on the computer keyboard is represented by one "byte," which is composed of a unique sequence of eight bits. This programming language is known as machine language or object code. Because it is difficult and cumbersome to program in object code, programming languages that use the standard 26-letter alphabet have been devised. Programming languages are divided into two basic types: low-level and high-level. Low-level languages, known as assembly languages, map the logic of the instructions that a microprocessor processes on a one-for-one basis. Programs written in assembly language are very efficient in their use of microprocessor memory. However, because of this one-to-one mapping to a particular microprocessor's instruction set, there is not "one" assembly language but rather one for every kind of microprocessor. In order for a program written in assembly language for a particular kind of microprocessor to

operate on a different kind of microprocessor, the program must be rewritten for the other platform. Therefore, programming in assembly languages takes longer, is expensive and requires a great deal of technical training and skill.

The problems inherent in low-level languages led to the development of high-level languages. From the perspective of the programmer, these high-level languages are easier to use and understand. Currently, the dominant high-level programming languages are:

COBOL - used for programming mainframe-based applications;

BASIC - used for database application front-end development and in education;

Pascal - used for education purposes;

C and C++ - the dominant programming languages used for developing "shrink-wrapped" Windows and Macintosh applications software, and used increasingly to develop software for 32-bit embedded systems; and

Java - used for networking-based applications where Java-optimized bytecodes can run on a variety of hardware, and do not need to be rewritten in native mode to run on each specified platform.

Because high-level languages use their own logic to solve problems and do not match the microprocessor's instruction set on a one-for-one basis, their "source code" must be translated, or compiled, into object code. This task is performed by software programs, known as compilers, which convert a software application written in source code into object code that a particular microprocessor can understand. Development of all software applications requires that source code be compiled into object code, and thus one of the most important tools a programmer uses is a compiler.

TECHNOLOGICAL TRENDS

The continuing evolution of computer technology has dramatically impacted the environment in which computer programmers must operate. The development of new programming languages and new operating systems, as well as the emergence of new types of microprocessors, have all created new demands on programmers.

One of the most significant changes has been the increased number of 32-bit microprocessors used in desktop and embedded systems. This shift resulted in the development of new operating systems for the desktop and embedded systems markets, the creation of major new microprocessors, such as Intel's Pentium® family of processors, the increased use of object-oriented programming languages, most notably C++ and Java, and the importance of networking and communications technology. Prior to the invention in the 1980's of relatively low-cost Dynamic Random Access Memory ("DRAM"), programmers went to great lengths to "optimize" their software to use as little memory as possible, resulting in relatively longer product development times. Today's competitive environment for desktop and embedded applications software requires that reliable software applications be developed with a wide variety of features and brought to market quickly and in a cost-effective manner. Today's programmer must balance optimization and use of memory and systems resources with time-to-market considerations.

The introduction and increasing use of Reduced Instruction Set Computing ("RISC") technology such as the PowerPC microprocessors now used in the Power Macintosh computer and the modified RISC architectures of the Pentium, Pentium Pro and Pentium II microprocessors, has also affected the applications software market. RISC-based microprocessors utilize different instruction sets than the traditional complex instruction set utilized in other common microprocessors such as Intel's X86 or Motorola's 68K family of microprocessors. Because of their relatively low cost, 32-bit RISC-based microprocessors are being utilized in embedded systems applications in consumer electronics products, hand-held computers, set-top boxes, game machines, telecommunications products, automotive products and other electronic systems. These 32-bit microprocessors permit more features and functionality than can be programmed into 4-, 8- or 16-bit microprocessors, which have lower computing power and memory capability.

NEEDS OF PROGRAMMERS

The Company believes that software companies and their programmers regard the following as critical attributes of programming tools:

- **Build Time.** The company believes that today, programmers are somewhat less concerned with optimizing a software product to the maximum extent possible and are more concerned with developing a reliable product with a wide variety of features and bringing it to the market quickly and in a cost-effective manner. Therefore, "build time," the time it takes to convert a set of source code instructions into a finished application, has become critically important to programmers. Shorter build times allow programmers more time to add features to an application and to test and debug the software.
- **Speed, Size and Quality of Object Code.** The speed at which a microprocessor runs object code or instructions can affect the product development process and marketability of the finished software applications. As software applications become more complex, the object code to be run by the microprocessor becomes increasingly longer. As a result, microprocessors run software applications at slower speeds and more memory is required to run the software. Therefore, while compilers must produce object code that is reliable and that can accurately run all of the features of the software, the object code must be compact enough so that the software applications runs quickly and does not require excessive memory.
- **Ease of Use.** Because of the sophisticated nature of software development and the large number and geographic dispersion of programmers, customer on-site visits are not always practical. Therefore, programming tools should be contained in a development environment that permits the use of tools in an integrated and user-friendly manner.
- **Frequency of Updates.** Due to the increased pace of microprocessor innovation, changes in operating systems and evolving standards for programming languages, programming tools must be updated frequently. Programmers must keep current with these changes so that the development process is not delayed by requiring programmers to spend time modifying the software applications to reflect such changes.
- **Sophisticated Debugging.** Because of the increasing complexity of software, programming tools must provide debugging capabilities sophisticated enough to permit programmers to test software quickly and thoroughly to identify and correct "bugs" in the software being developed. This need is particularly critical for developers of embedded applications, which are usually burned into read-only memory ("ROM").

The Company's vision is to be the leading high-volume provider of cost-effective standardized programming tools for software developers in the desktop and embedded systems markets. The Company has focused on providing developers with a single IDE that allows programmers to write software applications in a variety of programming languages targeted at a variety of microprocessors and operating systems used in the desktop and embedded systems markets. The key elements of the Company's strategy are as follows:

Broaden Product Offerings. The Company believes that its future success is highly dependent on its ability to market CodeWarrior products that have a variety of front-ends and back-ends in order to reach as large a group of potential customers as possible. In furtherance of this element of its strategy, the Company intends to:

Expand By Developing Back-Ends for Embedded Platforms. The Company's initial products had back-ends for Motorola 68K and PowerPC microprocessors used by the Macintosh computer. The Company has since developed back ends for the x86 and MIPS families of microprocessors. The Company is in the process of developing back ends for the NEC VR/V8xx, ARM and Hitachi SuperH families of microprocessors which are popular in the embedded systems market.

Increase Support for a Variety of Operating Systems. The Company currently supports development for desktop operating systems such as Windows 95 and Windows NT; and Mac OS; RTOS such as Nucleus OS, OS-9, Precise/MQX OS; and Tacit OS and proprietary embedded operating systems such as PlayStation OS and Palm OS. The Company anticipates supporting additional multi-purpose, RTOS and proprietary operating systems in the future. The Company's intention is to provide developers with the ability to target a variety of operating systems and the related microprocessors from the CodeWarrior IDE.

Partnering Agreements. The Company has entered into product development agreements with various companies. The details of these arrangements vary, but generally they provide that Metrowerks will develop programming tools and receive payments for both its development efforts and either ownership of, or a license to market, the developed programming tools. The other party to these agreements is generally permitted to utilize the developed tools for its own internal use, or in certain instances, to bundle the tools with hardware developed by such party. These partnering agreements have provided the Company with a significant amount of revenue, constituting approximately 26% of its revenue for fiscal 1997. As a result, the Company is able to devote more of its financial resources to research and development than it would otherwise be able to do. There can be no assurance that the Company will be able to continue to enter into these arrangements in the future.

Continued Enhancements to the Company's Windows 95 and Windows NT-Hosted Products. In fiscal 1997, the Company completed the port of its programming tools to be hosted on the Windows 95 and Windows NT operating systems which allows the Company's products to be used by programmers who are PC-hosted. The Company plans to add several functions to these tools in the near future, including a resource editor and rapid application development tools. These additions to the Company's Windows-95 and Windows-NT hosted tools will make the product more competitive with existing tools in this market. The Company believes that the majority of software applications for the embedded systems market is, and will continue to be, programmed on the Windows 95 and Windows NT-based desktop computers or UNIX-based workstations. By improving the quality of its tools in this market, the Company hopes to expand its base of potential embedded systems programmers as well as increase its penetration into the market of Windows-hosted programmers developing applications for the Windows 95 and the Windows NT operating systems.

Target the Educational Market. The Company currently markets its CodeWarrior Academic products to universities, colleges and high schools and many have standardized on CodeWarrior for computer programming classes. Use of CodeWarrior as a standardized programming tool in the teaching of programming eliminates the need for professors to teach students one development environment on Windows and a different one on Macintosh. The Company believes that if computer programming students become familiar with the Company's programming tools while they are in school they may be more likely to utilize its products when they enter the job market.

Distribution. Because of the relatively low retail price of the Company's products, it is not economically feasible for the Company to emphasize direct sales as a method of distribution. Accordingly, the Company relies and intends to continue to rely on indirect methods of distribution, such as distributors and mail order catalogs, for its products. The embedded systems market has historically been a direct sales market and there can be no assurance that the Company will be able to locate these distributors for its embedded systems products.

Maintain Leadership in the Macintosh Computer Market. The Company believes that its CodeWarrior products have become the industry standard for Macintosh computer-hosted programming tools and that its CodeWarrior products have been used to program over 75% of all commercially available software applications for the Power Macintosh computer. The Company's intention is to maintain this position through continued enhancements to its Macintosh tools.

There can be no assurance that any of these new platforms, operating systems or programming languages or that any of the Company's proposed programming tools will achieve commercial success. Failure of a particular platform for which the Company has developed a back end or a programming language for which the Company has developed a front end would result in reduced demand for software applications that run on the platform or in the programming language, which in turn could adversely affect the Company's business, financial condition and results of operations. See "Additional Risk Factors-Importance of New Products and Technological Change."

RESEARCH AND DEVELOPMENT

The Company continues to make substantial investments in research and development. While the Company believes that its future performance will depend upon the success of its research and development efforts, it believes that the modular design of its CodeWarrior products provides it with the ability to incrementally add a new back end (for a new platform or operating system) or a new front-end (for a new programming language), thereby significantly reducing both the cost and the time-to-market required to release new tools for such new platform, operating system or programming language, than it would otherwise face if it had to develop an entirely new set of programming tools.

The Company has a program, "Metrowerks Permanent Testing Partners," which helps supplement the Company's product testing efforts. The Company has a testing group of over 1,000 customers. This testing group is provided with product updates or new releases in advance of their release to the public. The members of this group utilize the product and notify the Company of any errors in the product, which are then subsequently corrected by the Company's research and development department prior to the general release of the product. The Company believes that its Metrowerks Permanent Testing Partners program provides it with additional product testing and quality control capabilities at very little additional cost.

The Company has also supplemented its internal product development efforts through external product development agreements. Such funding is generally pursuant to agreements with third parties which provide for the Company to develop programming tools for a specific platform designed by the third party. The Company receives product development fees, generally to be paid subject to the Company meeting performance standards and development milestones, which are usually sufficient to cover all or a substantial portion of the Company's research and development costs. The Company either owns, or is generally granted a license to market, these programming tools with its products. The Company recorded revenues of approximately US\$613,000, US\$2.3 million and US\$4.7 million pursuant to these product development agreements for fiscal 1995, 1996 and 1997, respectively. While the Company believes that such development funding will continue to be available in varying amounts in the future, there can be no assurance that the Company will continue to be able to enter into such software development arrangements.

Because of the need to develop new products, the Company has invested, and continues to invest, substantial resources in its product development efforts. At July 31, 1997, the Company's research and development staff constituted approximately 54% of the Company's employees, having grown from 65 employees at July 31, 1996 to 90 employees at July 31, 1997. The Company also relies on independent contractors for some of its research and development projects. The Company incurred costs of approximately US\$1.6 million, US\$3.3 million and US\$6.5 million on research and development activities for fiscal 1995, 1996 and 1997. Such expenditures constituted 31%, 31% and 35% of revenue, respectively, for such periods.

The Company has historically released new versions of, or updates for, its CodeWarrior products at least three times a year. Beginning with the release of CodeWarrior Professional in May 1997, the Company changed its policy of releasing, or updating, new versions of its CodeWarrior products to twice a year. The success of new product introductions and updates depends upon several factors, including recognition of market requirements, product cost, timely completion and introduction of new products and the targeted platform, operating system or programming languages, and quality of new products and such platforms, operating systems or programming languages. There can be no assurance that the Company will not encounter delays in the development and introduction of future products. Software products as complex as those offered by the Company may also contain undetected errors when first introduced or as updates are released. Although the Company has

not experienced any material errors in its products, there can be no assurance that, despite testing by the Company, errors will not be found in new products after commencement of commercial shipments, resulting in a loss of or delay in market acceptance. There can also be no assurance that the Company will successfully identify new product opportunities and develop and bring new products to market in a timely manner, that the Company's products will be accepted by its targeted customers or utilized in connection with its targeted applications or that products or technologies developed by other companies will not render the Company's products or technologies obsolete or noncompetitive. Further, the success of certain of the Company's new tools will depend in part on the amount of software applications developed for a new platform, operating system or programming language, which in turn will depend upon the commercial success of such platform, operating system or programming language introduced by other companies. The failure of the Company's new product development efforts or the lack of market acceptance for the Company's new tools would have a material adverse effect on the Company's business, financial condition and results of operations. The failure of any new platform, operating system or programming language for which the Company may have devoted substantial resources in developing new tools would also have a material adverse effect on the Company's business, financial condition and results of operations. See "Additional Risk Factors-Importance of New Products and Technological Change" and "Risk Factors-Software Defects."

SALES AND MARKETING

Sales. Because of the relatively low retail price of the Company's products, it is not economical for the Company to, and the Company does not, emphasize direct sales for its product distribution. The Company sells its products through major distributors such as Ingram Micro, Inc., and Merisel Americas, Inc., which sell to retail stores and mail-order catalogs in the United States and Canada and through distributors that sell to academic institutions. CodeWarrior is listed in a variety of mail-order catalogs, including MacWarehouse and PC/MacConnection, two of the largest mail-order software distribution catalogs specializing in the North American computer market. The Company believes that software programmers, which are its primary target customers, frequently utilize mail-order channels rather than retail stores because of the lower prices offered through such mail order companies. Accordingly, the Company continues to emphasize mail-order distribution as a significant method of marketing.

Outside of the United States and Canada, the Company sells through distributors in 22 countries. In fiscals 1995, 1996 and 1997, sales outside of North America were US\$856,000, US\$1.9 million and US\$4.4 million, respectively. Approximately 24% of the Company's registered users are located outside the United States. The Company relies primarily on distributors to generate international sales. The Company generally enters into distribution agreements with these distributors for a one or two year term, with provisions for annual renewals thereafter. Product localization (such as translation of user interface prompts and packaging) is performed for the Company by third parties and by the Company's Japanese subsidiary.

The Company also maintains a direct sales force of 11 persons at its Austin, Texas facilities. For the fiscal year ended July 31, 1997, direct sales, including subscription renewals, accounted for approximately 18% of the Company's product sales. The Company's direct sales force is primarily responsible for negotiating site licenses with larger U.S. customers and fulfilling subscription renewals.

The Company also offers a toll free telephone number for orders which are processed and filled by the Company's operations center in Austin, Texas. In the event of the emergence of new distribution channels such as on-line services and other electronic distribution, the Company may, if cost effective, explore additional methods of distribution.

Marketing. The Company markets its products through trade show exhibits and conferences, presentations to large groups of end-users and advertisements in various software catalogs and magazines. All marketing, advertising and public relations activities are performed by the Company's marketing group.

CUSTOMERS

As of July 31, 1997, the Company had over 100,000 registered users of its CodeWarrior products. Most of the Company's customers are small independent software vendors who generally purchase one copy of the Company's products. A large number of students, researchers in academia and university computer science labs use the Company's academic product line. During fiscal 1997, no one end user accounted for more than 1% of the Company's product sales.

CUSTOMER AND TECHNICAL SUPPORT SERVICES

The Company believes in providing timely, high quality technical support, which it believes is critical to maintaining customer satisfaction and is an important element of the value it provides to customers. The Company provides telephone, electronic mail and fax-based customer support from 8:00 a.m. to 7:00 p.m., C.S.T., five days per week and has a nine member technical support staff. Members of the Company's technical support staff typically have several years of experience in areas such as software engineering, software testing or tools development. Most customer support services for the Company's customers outside North America are provided through its international distributors; however, the Company provides the distributors with any needed technical assistance.

COMPETITION

The marketplace for professional programming tools is intensely competitive. Given the variety of platforms and operating systems on or for which the Company's products operate, the Company faces competition from many companies. While many of the Company's competitors are software vendors or other technology companies who offer products for sale to the public, the Company also faces competition, particularly in the embedded systems market, from platform manufacturers who develop software applications and programming tools internally, and who are therefore less inclined to purchase programming tools from a third party. See "Additional Risk Factors - Competition." The Company believes that it must continue to develop new products and introduce enhancements to its existing products in a timely manner to remain competitive. Even if the Company introduces new and enhanced products, it may not be able to compete effectively because of the significantly larger resources available to many of its competitors. The Company's ability to compete successfully also depends on a number of other factors both within and outside of its control, including: product pricing; product quality and performance; its ability to attract and retain key employees; effectiveness of its sales and marketing; timing of new product introductions by the Company, its competitors and creators of new hardware platforms; general market and economic conditions; and government actions throughout the world. There can be no assurance that the Company will be able to compete successfully or that competition will not have a material adverse effect on the Company's business, financial condition and results of operations.

Embedded Systems. The market for programming tools for the embedded systems market is fragmented, highly competitive and characterized by rapid technology advances. The Company's success will depend on the continued enhancement of its current products. The Company's products compete with tools developed internally by companies and tools offered by third parties. Many platform manufacturers, telecommunications companies and automotive manufacturers, to name a few, develop software applications and programming tools internally (proprietary systems), and accordingly, the Company believes they are less inclined to purchase tools from a third party. In addition, the Company faces competition from third-party embedded software providers of operating systems and tools such as Wind River Systems, Inc., Integrated Systems, Inc., Microsoft Corporation, GreenHills Software, Inc. and Cygnus Solutions. Many of the Company's existing and potential competitors have substantially greater financial, technical, marketing and sales resources than the Company.

Windows 95 and Windows NT Programming Tools. The Company's PC-hosted tools are new to the market and will need to add additional features to compete with other PC-hosted programming tools. The Company faces significant and intense competition from Microsoft, Borland and Watcom in this market. All of these companies are well established, have strong brand name recognition, and have substantially greater financial, technical and marketing re-sources than the Company. There can be no assurance that the Company will be able to compete successfully with these companies.

Macintosh Programming Tools. With respect to its programming tools for the MacOS, the Company faces competition from Symantec's Java-based tools. For Rhapsody, Apple Computer's next generation operating system, the Company faces significant potential competition from Apple Computer. Symantec and Apple Computer have substantially greater financial, technical and marketing resources than the Company. The Company estimates that over 75% of the Power Macintosh applications available today were built with CodeWarrior. As Apple Computer ("Apple") is expected to move to Rhapsody in the second half of 1998, the Company has announced that it will release development tools for the new operating system. Apple has also announced their intentions of developing tools for the new operating system, and there can be no assurance that the Company will be able to maintain its current market share.

INTELLECTUAL PROPERTY

The Company regards its software as proprietary and attempts to protect it with copyrights, trademarks, trade secret laws, restrictions on disclosure and transferring title and other methods, rather than patents. Despite these precautions, it may be possible for unauthorized third parties to copy certain portions of the Company's products and obtain and use information the Company regards as proprietary. While the Company's competitive position may be affected by its ability to protect its proprietary information, the Company believes that copyright protections are less significant to the Company's success than other factors, such as trade secret protection, the knowledge, ability and experience of the Company's personnel, name recognition and ongoing product development and support.

The Company licenses its products primarily under "shrink wrap" licenses (that is, licenses included as part of the product packaging). Shrink wrap licenses are not negotiated with or signed by individual licensees and purport to take effect upon the opening of the product package. Certain provisions of such licenses, including provisions protecting against unauthorized use, copying, transfer and disclosure of the licensed program, may be unenforceable under the laws of certain jurisdictions. In keeping with industry standards, the Company does not copy protect its software. Accordingly, it may be possible for unauthorized parties to copy or reverse engineer the Company's products or otherwise obtain and use information that the Company regards as proprietary. Furthermore, there can be no assurance that the Company's competitors will not independently develop technologies that are substantially equivalent or superior to the Company's products. Policing unauthorized use of the Company's products is difficult, and while the Company is unable to determine the extent of software piracy of its products, software piracy can be expected to be a persistent problem. In addition, the laws of some foreign countries do not protect the Company's proprietary rights to the same extent as do the laws of the United States and Canada.

As the number of software products in the industry increases and the functionality of these products further overlaps, the Company believes that software programs will increasingly become subject to infringement claims. There can be no assurance that third parties will not assert infringement claims against the Company in the future with respect to current or future products. Any such assertion could require the Company to enter into license or royalty arrangements or result in costly litigation. There can be no assurance that such license or royalty agreements will be available on reasonable terms or at all.

Although the Company believes that it currently owns or has adequate rights to utilize all material technologies relating to its existing products, as it develops new back ends and front ends for its CodeWarrior products, it anticipates that it may find it desirable or necessary to obtain other licenses from third parties entitling it to use certain technologies. There can be no assurance that such licenses would be available to the Company on acceptable terms, if at all. The Company currently

has non-exclusive licenses to certain software programs from Microsoft, a competitor of the Company. The licensed technologies are incorporated in the Company's Windows 95 and Windows NT hosted products. These licenses will expire upon the next major release of Windows 95 and Windows NT. The Company licenses operating system software from Apple pursuant to a non-exclusive license. The Company pays a license fee to Apple for this licensed technology. The agreement has a term of one year and is automatically renewable for successive one-year terms, subject to earlier termination by Apple upon nine month's written notice. In connection with the development of its programming tools for the Java programming language, the Company has a non-exclusive license with Sun Microsystems ("Sun") to use or modify the Java programming language for the purpose of developing a Java-based CodeWarrior product. This license is for an initial five-year term and is renewable by the Company for up to five successive one-year terms. The Company pays Sun a royalty based upon the number of CodeWarrior products sold that incorporate the Java technology. Termination by Microsoft, Apple or Sun or the lapse of these agreements would require product redesign and could significantly increase research and development costs or would require the Company to obtain licenses from third parties, which may not be available to the Company on acceptable terms, if at all. The Company's loss or inability to obtain necessary or desirable licenses from third parties could have a material adverse effect on the Company's business, financial condition or results of operations. See "Additional Risk Factors-Proprietary Technology."

PRODUCTION AND BACKLOG

The Company's manufacturing operations consist of assembling, packaging and shipping the software products and documentation needed to fulfill each order. All fulfillment and shipping is currently performed in Austin, Texas. The Company's products are CD-ROM based. The Company produces its own CD-ROM master disks, with disk duplication performed by third parties. Other than software user documentation, the Company does not ship documentation such as user manuals with its product, although a copy of such documentation is available on the CD-ROM disk and a printed version is available to users for an additional fee.

The Company does not believe that backlog is a meaningful indicator of sales that can be expected in future periods, particularly in view of the fast pace of technological change in the software industry. The Company generally ships its products within a few days after acceptance of a customer purchase order and, therefore, has insignificant product backlog. Product development agreement revenue backlog was approximately US\$780,000 as of July 31, 1997.

EMPLOYEES

As of July 31, 1997, the Company employed 167 full-time personnel, including 90 in research and development; 9 in technical support; 37 in sales and marketing; and 31 in management and administration. The Company's employees are not represented by any collective bargaining organization, and the Company has never experienced a work stoppage. The Company believes its success will depend in part on its continued ability to attract and retain highly qualified personnel in a competitive market for experienced and talented software engineers and sales and marketing personnel. See "Additional Risk Factors - Dependence on Key Personnel."

ADDITIONAL RISK FACTORS

Fluctuations in Quarterly Results. The Company has experienced significant period-to-period fluctuations in revenues and operating results and anticipates that such fluctuations will continue. These fluctuations may be attributable to a number of factors, including the volume and timing of orders received during the quarter, the timing and acceptance of new products and product enhancements by the Company or its competitors, stages of product life cycles, purchasing patterns of customers and distributors, market acceptance of products sold by the Company's customers, competitive conditions in the industry, business cycles affecting the markets in which the Company's products are sold, extraordinary events, such as acquisitions, including related charges, and economic conditions generally or in specific geographic areas. The future operating results of the Company may fluctuate as a result of these and other factors, including the Company's ability to con-

tinue to develop innovative and competitive products. In addition, the Company has not entered into long-term product development agreements with its customers, and the timing of product development agreement fees is difficult to predict. The procurement process of the Company's customers is often several months or longer from initial inquiry to order and may involve competing considerations. Further, as licensing of the Company's products increasingly becomes a more strategic decision made at higher management levels, there can be no assurance that sales cycles for the Company's product will not lengthen. Product revenue in any quarter depends on the volume and timing of orders received in that quarter. Because the Company's staffing and operating expenses are based on anticipated total revenue levels and a high percentage of the Company's costs are fixed in the short term, small variations between anticipated orders and actual orders, as well as non-recurring or large orders, could cause disproportionate variations in the Company's operating results from quarter to quarter.

A number of additional factors may cause the Company's revenues and operating results to vary significantly from period to period. These factors include: software "bugs" or other product quality problems, changes in operating expenses, changes in Company strategy, personnel changes, foreign currency exchange rates, and mix of products sold. Although the Company has seen significant revenue growth for the last several years, there can be no assurance that the Company will be able to continue its growth in revenue or profits on a quarterly or annual basis. Due to all of the foregoing factors, the Company believes that period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as an indication of future performance. It is possible that, in some future quarters, the Company's operating results could be below the expectations of stock market analysts and investors. In such event, the price of the common stock could be materially and adversely affected.

Importance of New Products and Technological Change. The market for embedded programming tools is fragmented and the market for desktop and embedded programming tools is characterized by ongoing technological developments, evolving industry standards and rapid changes in customer requirements. The Company's success depends upon its ability to continue to develop and introduce in a timely manner new products that take advantage of technical advantages, to continue to enhance its existing product lines, to offer its products across a spectrum of microprocessor families and operating systems used in the embedded systems market and to respond promptly to customers' requirements. The Company must continuously update its existing products to keep them current with changing technology and must develop new products to take advantage of new technologies that could render the Company's existing products obsolete. The Company has historically experienced minor delays in the development of new products. Such delays are common in the software industry and are likely to be experienced by the Company in the future. The Company's future prospects depend upon the Company's ability to increase the functionality of existing products in a timely manner and to develop new products that address new technologies and achieve market acceptance. New products and enhancements must keep pace with competitive offerings, adapt to evolving industry standards and provide additional functionality. There can be no assurance that the Company will be successful in developing and marketing, on a timely basis or at all, competitive products, product enhancements and new products that respond to technological change, changes in customer requirements and emerging industry standards, or that the Company's new or enhanced products will adequately address the changing needs of the marketplace. The inability of the Company, due to resource constraints or technological or other reasons, to develop and introduce new products or product enhancements in a timely manner could have a material adverse effect on the Company's business, financial condition or results of operations. From time to time, the Company or its competitors may announce new products, capabilities or technologies that have the potential to replace or shorten the life cycles of the Company's existing products. There can be no assurance that announcements of currently planned or other new products will not cause customers to defer purchasing existing Company products. Any failure by the Company to anticipate or respond adequately to changing market conditions, or any significant delays in product development or introduction, would have a material adverse effect on the Company's business, financial condition and results of operations. If the results of product development efforts are inadequate or delayed, the Company's business, financial condition and results of operations would be materially adversely affected.

PART II

ITEM 5. Market for Registrant's Common Equity and Related Stockholder Matters

Metrowerks' common stock is traded on the Nasdaq National Market under the symbol MTWKF and The Toronto Stock Exchange and the Montreal Exchange under the symbol MWK.

The closing price of the Company's common stock as reported by the Nasdaq National Market as of July 31, 1997 was US\$6.38 per share. The price per share in the following table sets forth the low and high prices in the Nasdaq National Market for the quarter indicated (all amounts in US \$):

	LOW	HIGH
Fiscal 1996		
First quarter ended October 31, 1995	\$ —	\$ —
Second quarter ended January 31, 1996	—	—
Third quarter ended April 30, 1996	—	—
Fourth quarter ended July 31, 1996	10.72	13.61
Fiscal 1997		
First quarter ended October 31, 1996	\$ 9.25	\$ 12.00
Second quarter ended January 31, 1997	7.00	11.25
Third quarter ended April 30, 1997	4.88	9.75
Fourth quarter ended July 31, 1997	4.00	7.75

The closing price of the Company's common stock as reported by The Toronto Stock Exchange as of July 31, 1997 was Canadian \$9.35 per share. The price per share in the following table sets forth the low and high prices in The Toronto Stock Exchange for the quarter indicated (all amounts in Canadian \$):

	LOW	HIGH
Fiscal 1996		
First quarter ended October 31, 1995	\$ 4.75	\$ 6.12
Second quarter ended January 31, 1996	6.37	21.50
Third quarter ended April 30, 1996	12.00	18.25
Fourth quarter ended July 31, 1996	12.50	18.55
Fiscal 1997		
First quarter ended October 31, 1996	\$ 12.75	\$ 16.15
Second quarter ended January 31, 1997	9.50	14.30
Third quarter ended April 30, 1997	7.00	12.75
Fourth quarter ended July 31, 1997	5.50	10.50

The Company has not paid dividends and does not plan to pay dividends on its common stock in the foreseeable future. The Company presently intends to reinvest earnings to fund future growth. At July 31, 1997, there were approximately 59 stockholders of record of the Company. Certain record holders are represented by brokers and other institutions on behalf of stockholders. The Company believes the total number of beneficial owners of its common stock to be 1,000.

ITEM 6. Selected Consolidated Financial Data

The following selected consolidated financial data should be read in conjunction with the Consolidated Financial Statements, including the Notes to Consolidated Financial Statements included elsewhere in this report.

	Year Ended July 31,				
	1993	1994	1995	1996	1997
(in thousands of U.S. dollars, except share and per share amounts)					
Statement of Operations Data:					
Revenue, net	\$ 184	\$2,040	\$5,143	\$10,619	\$18,293
Cost of sales	33	207	910	2,664	4,563
Gross margin	151	1,833	4,233	7,955	13,730
Operating expenses:					
Research and development	514	1,080	1,574	3,250	6,486
Selling, administrative and technical support	218	1,053	2,348	4,622	8,109
Depreciation of property and equipment	13	66	155	355	1,154
Non-recurring charge	—	—	—	—	4,297
Total operating expenses	745	2,199	4,077	8,227	20,046
Operating income (loss) from operations	(594)	(366)	156	(272)	(6,316)
Other income:					
Interest income and other	5	34	98	377	341
Net earnings (loss)	\$ (589)	\$ (332)	\$ 254	\$ 105	\$ (5,975)
Net earnings (loss) per share(1)	\$ (0.09)	\$ (0.05)	\$ 0.03	\$ 0.01	\$ (0.52)
Weighted average number of common and common equivalent shares outstanding (1)	6,336	6,904	7,956	10,620	11,523

	July 31,				
	1993	1994	1995	1996	1997
(in thousands of U.S. dollars)					

Balance Sheet Data:

Cash and cash equivalents	\$ 377	\$ 767	\$4,746	\$11,498	\$5,042
Total assets	691	1677	6,634	18,305	14,168
Long-term debt, less current portion	329	201	—	—	—
Total stockholders' equity	(691)	473	5,571	16,437	10,562

(1) For an explanation of the determination of the number of shares used in computing per share amounts and the weighted average number of common stock outstanding, see Note 1 to the Financial Statements.

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

All dollar amounts referred to in this section are in thousands of U.S. dollars.

FORWARD-LOOKING INFORMATION

Statements in this report concerning expectations for the future constitute forward-looking statements which are subject to a number of known and unknown risks, uncertainties and other factors which may cause actual results, performance or achievements of the Company or industry trends to differ materially from those expressed or implied by such forward-looking statements. Relevant risks and uncertainties include, among others, those discussed in Item 1 of Part I under the heading "Additional Risk Factors" and elsewhere in this report and those described from time to time in the Company's other filings with the Securities and Exchange Commission, press releases and other communications.

OVERVIEW

Metrowerks designs, develops, markets and supports professional software programming tools. The Company's products are used primarily by professional software programmers, and by programmers in the academic community, to develop software application for a variety of platforms, including Windows 95 and Windows NT operating systems used by PCs; the Mac OS operating system used by the Macintosh and Power Macintosh computers; and for proprietary and multi-purpose real-time embedded operating systems.

The Company derives substantially all of its revenue from a limited number of products. The Company's future revenue is substantially dependent upon the continued acceptance of its CodeWarrior products. The Company is also in the process of developing a number of new products and new versions of existing products and believes that its future revenue will depend upon the commercial success of these new products. There can be no assurance that the Company's new products will achieve market acceptance.

The Company also derives a significant portion of its revenue from product development agreements pursuant to which the Company receives payments from a third party for developing programming tools for a particular platform, operating system or programming language. The amount of revenue the Company receives from this particular source will depend upon the number of such agreements to which the Company is a party during such quarter and the timing of deliverables under such agreements. Further, there can be no assurance that the Company will be able to continue to enter into such development agreements in the future. The Company's product development efforts have also entailed significant research and development expenditures. In addition, to enhance its competitive position in the future, it will be necessary for the Company to broaden its product offerings. This objective may require expansion of the Company's internal product development efforts or acquisitions of or investments in complementary businesses, products or technologies. Furthermore, if the Company were unable to enter into new software development agreements in the future, the Company would, at a minimum, have to increase its internal research and development expenditures. These higher expense levels combined with fluctuations in revenue could affect the Company's quarterly and annual results and result in fluctuations in its operating results. The Company intends to continue to invest significant amounts in expanding its product line, and, accordingly, may continue to experience losses and volatility of revenue and operating results in future periods. The Company believes that the recent revenue growth rates should not be relied upon as an indication of revenue growth rates for future periods.

The Company has and will continue to make certain investments in its software systems and applications to ensure the Company is year 2000 compliant. The financial impact to the Company has not been and is not anticipated to be material to its financial position or results of operations in any given year.

On August 1, 1995, the Company adopted the United States dollar as its reporting currency, and the historical consolidated financial statements have been restated to present amounts in United States dollars.

RESULTS OF OPERATIONS

The following table sets forth certain items from the Company's consolidated statement of income as a percentage of revenue for the periods indicated.

	As a Percentage of Revenue				
	Years ended July 31,				
	1993	1994	1995	1996	1997
Revenue, net	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of sales	17.9	10.2	17.7	25.1	24.9
Product margins ⁽¹⁾	82.1	85.9	77.5	63.2	62.8
Operating expenses:					
Research and development	279.3	52.9	30.6	30.6	35.5
Selling, administrative and technical support	118.5	51.6	45.7	43.5	44.3
Depreciation of property and equipment	7.1	3.2	3.0	3.3	6.3
Non-recurring charge	—	—	—	—	23.5
Total operating expenses	404.9	107.7	79.3	77.4	109.6
Operating income (loss) from operations	(322.8)	(17.9)	3.0	(2.5)	(34.5)
Other income:					
Interest income and other	2.7	1.7	1.9	3.5	1.8
Net earnings (loss)	(320.1)%	(16.2)%	4.9%	1.0%	(32.7)%

(1) Product margins are based on product revenues and costs of product sales only.

REVENUE

The Company recognizes revenue from the sale of its products upon the later of shipment or the satisfaction of all significant Company obligations. All revenue is derived from unaffiliated customers. Product returns are estimated and provided for at the time of sale. Such return allowances as a percentage of revenue have varied significantly over recent years and periods, reflecting the Company's experience in product returns as it has significantly expanded the proportion of its sales through third-party distribution channels and increased its product portfolio. The Company expects return allowances will continue to vary in the future. The Company's agreements with its distributors generally provide the distributors with limited rights to return unsold inventories under a stock balancing program. The Company monitors activities of its distributors in an effort to minimize excessive returns and establishes its return allowances based on its estimates of expected returns. While historically the Company's returns have been within expectations, the establishment of return allowances requires judgments regarding such factors as future competitive conditions and product acceptance, which can be difficult to predict.

The Company also derives revenue from product development agreement fees. Product development agreement fees related to software development are recognized on a percentage of completion over the term of the contract, and are included in revenue in the income statement.

Total revenue, a substantial portion of which has been derived from sales of the Company's CodeWarrior professional programming tools, increased from \$5,143 in fiscal 1995 to \$10,619 in fiscal 1996 and increased 72% in fiscal 1997 to

\$18,293. The increase in total revenue in fiscal 1996 was due primarily to increased product sales of CodeWarrior for Mac OS as our subscriber base increased from approximately 20,000 registered users at July 31, 1995 to 50,000 users at July 31, 1996. In fiscal 1997, product revenues increased \$5,222 from \$8,356 in fiscal 1996 to \$13,578 in fiscal 1997. The increase in product revenues in fiscal 1997 is due primarily to the introduction of new products in the embedded systems market. In fiscal 1997, the Company launched CodeWarrior for PalmPilot, CodeWarrior for Sony PlayStation and CodeWarrior for PowerPC Embedded Systems. All three products contributed significantly to the increase in product revenue for fiscal 1997. In addition, the Company saw an increase in sales of desktop products as we added CodeWarrior hosted on Windows 95 and Windows NT to our product list. In particular, academic sales increased from fiscal 1996 to fiscal 1997 as universities adopted CodeWarrior for its multi-language, cross-platform development capabilities. The Company's subscriber base increased to over 100,000 registered users at July 31, 1997.

In 1996, alliances with new partners such as Microsoft, Sony and Motorola resulted in an increase in product development agreement revenues of \$1,650 from \$613 in fiscal 1995 to \$2,263 in fiscal 1996. Product development agreement revenues increased to \$4,715 in fiscal 1997, an increase of 108%. The increase was the result of new product development agreements in fiscal 1997, including partnerships with NEC, Motorola, Microsoft and Microware.

COST OF SALES AND PRODUCT MARGIN

Cost of sales consists primarily of the cost of product media and duplication, the cost of packaging materials, amortization of capitalized research and development costs, royalties and shipping expenses. Costs associated with product development agreement revenues are included in research and development expenses and are not separately identified and approximate revenue. Cost of sales increased from \$910 in fiscal 1995 to \$2,664 in fiscal 1996 and increased 71% to \$4,563 in fiscal 1997, representing 22%, 37% and 37% of product revenue, respectively. The increase in cost of sales as a percentage of product revenue from fiscal 1995 to fiscal 1996 resulted from royalty payments paid by the Company in 1996 which did not exist in 1995. Margins were also adversely affected by increased sales of hardware, such as General Magic Inc.'s Magic Cap Communicator and the 3Com PalmPilot, which have lower margins than software products. Cost of sales as a percentage of product sales remained flat from fiscal 1996 to fiscal 1997. The Company changed its production and fulfillment operations in fiscal 1997 by bringing in-house all packaging, fulfillment and shipping operations. The effects of this adjustment were not felt until the fourth quarter of fiscal 1997 when cost of sales, as a percentage of product sales, decreased to 21%.

OPERATING EXPENSES

Selling, administrative and technical support costs increased from \$2,348 in fiscal 1995 to \$4,622 in fiscal 1996 and increased 75% to \$8,109 in fiscal 1997, representing 46%, 44% and 44% of total revenue, respectively. The increases in 1996 and 1997 resulted from the Company's focus on developing the infrastructure necessary to provide support for the Company's growth and expansion into new markets. These costs are primarily personnel related, as the Company's selling, administrative and technical support headcount has increased from 21 at July 31, 1995 to 60 at July 31, 1996 and to 77 at July 31, 1997, with the majority of the increase in headcount between 1995 and 1996 having occurred in the later part of 1996.

Depreciation costs increased from \$155 in fiscal 1995 to \$355 in fiscal 1996 and increased 225% to \$1,154 in fiscal 1997, representing 3%, 3%, and 6% of total revenue, respectively. The increase in 1997 resulted from significant investments in property and equipment necessary to provide support for the Company's personnel growth during these periods.

Research and development costs increased from \$1,574 in fiscal 1995 to \$3,250 in fiscal 1996 and increased 100% to \$6,486 in fiscal 1997, representing 31%, 31% and 35% of total revenue, respectively. Research and development expenditures consisted primarily of personnel-related costs. Increases in expenses were due primarily to the growth of the Company's research and development team required to expand and enhance the Company's product line. The Company's research and development headcount increased from 36 at July 31, 1995 to 65 at July 31, 1996 and to 90 at July 31, 1997.

NON-RECURRING CHARGE

The Company recorded a non-recurring charge of \$4,297 in the quarter ended April 30, 1997 related to the write-off of certain assets associated with the Mac OS. The decision to record this charge was based on the significant decline in sales of Mac OS-related products. In 1997, the Company accelerated its diversification efforts to focus on the Windows and embedded systems markets and believed that the Mac OS-related assets were significantly impaired.

PROVISION FOR INCOME TAXES

As a result of accumulated operating losses, the Company did not record any provisions for income taxes in 1995, 1996 or 1997. As of July 31, 1997, the Company had net operating loss carryforwards of approximately \$4,670, which begin to expire in 2000. If the Company records profits in future periods, such losses may reduce the amount of taxes payable.

LIQUIDITY AND CAPITAL RESOURCES

Since its inception, the Company has financed its cash requirements from cash generated from operations, the sale of equity securities, bank lines of credit and long-term and short-term debt. At July 31, 1997 the Company has cash and cash equivalents of \$5,042 and no long-term debt. Metrowerks has working capital of approximately \$7,516 at July 31, 1997 compared to \$13,519 at July 31, 1996.

In fiscal 1996 and 1997, the Company's operating activities consumed cash of approximately \$1,405 and \$2,867, respectively. In both fiscal 1996 and 1997, the primary cause of the use in cash from operations was the increase in receivables resulting from increased sales and increased use of third party distributors. In fiscal 1997, the Company's net loss of \$5,975 included a non-cash charge of \$4,297 related to the write-off of certain assets as described above.

The Company has made significant investments in technology in both fiscal 1996 and 1997 and had cash expenditures of \$1,599 and \$2,385, respectively, for property and equipment. Total cash used for investment activities was \$2,604 and \$3,689, in fiscal 1996 and 1997, respectively.

In March 1996, the Company completed an offering of 1,000,000 common shares for net proceeds of \$10,341 to obtain the financial resources needed for execution of its expansion into the embedded systems, Windows and Java markets. Total cash provided by financing activities was \$10,761 and \$100 in fiscal 1996 and 1997, respectively.

The Company currently anticipates that existing funds together with anticipated cash flow from operations, will be sufficient to meet its working capital and capital expenditure requirements for at least the next twelve months. To the extent that these sources of funds are insufficient to meet these requirements, the Company will be required to raise additional funds. Possible sources of financing include the sale of equity securities or borrowings from banks. The sale of additional equity or convertible debt securities could be dilutive. There can be no assurance that the Company will be able to obtain financing on commercially reasonable terms, if at all, in the future.

Item 7a. Quantitative and Qualitative Disclosures About Market
Risk

Not applicable.

Item 8. Financial Statements and Supplementary Data

See "Index to Consolidated Financial Statements" on F-1 for a listing of the consolidated financial statements filed with this report.

Item 9. Changes in and Disagreements with Accountants on
Accounting and Financial Disclosures

None.

PART III.

Item 10. Directors and Executive Officers of the Registrant

The directors of the Company, and certain information about them as of July 31, 1997, are as follows:

Name and Office	Director Since	Principal Occupation for Past Five Years
Jean Bélanger Director, Chairman of the Board & CEO	January 1, 1990	Chairman and Chief Executive Officer of the Company; prior to July 1996, Chairman of the Board of the Company
Greg Galanos ⁽²⁾⁽³⁾ Director, President & Chief Technology Officer	January 1, 1990	President and Chief Technology Officer of the Company; prior to July 1996, President and Chief Executive Officer of the Company
David Perkins Director, Senior VP, Sales & Business Development	June 29, 1995	Senior Vice President, Sales and Business Development of the Company; from May 1995 to July 1996, Vice President, Finance and Chief Financial Officer of the Company; from October 1991 to April 1995, Partner, Coopers & Lybrand
Stephen Lockyer ⁽¹⁾⁽²⁾⁽³⁾⁽⁴⁾ Director	May 4, 1992	President of Cornwallis Financial Corporation, a financial services company
Tom Woods ⁽¹⁾⁽⁴⁾ Director	January 30, 1996	Managing Director, CIBC Wood Gundy Securities Inc., a securities dealer
Geoff Beattie ⁽¹⁾⁽⁴⁾ Director and Secretary	October 28, 1996	Partner, Tory Tory DesLauriers & Binnington, a law firm
Peter Tolnai ⁽¹⁾⁽²⁾⁽³⁾ Director	August 21, 1997	President of Orchard Capital Group Inc., a private equity investment fund; from January 1995 to March 1997, Vice President of Citibank Canada; prior to January 1995, Managing Director, Clairvest Group Inc.

(1) Member of the Company's Audit Committee.

(2) Member of the Company's Stock Option Committee.

(3) Member of the Company's Compensation Committee.

(4) Member of the Company's Corporate Governance and Nominating Committee.

The executive officers of the Company, and certain information about them as of July 31, 1997, are as follows:

Name	Age	Position with the Company
Jean Bélanger	43	Chairman, Chief Executive Officer & Director
Greg Galanos	39	President, Chief Technology Officer & Director
David Perkins	35	Senior Vice President, Sales & Business Development & Director
Berardino Baratta	27	Vice President, Research and Development
John Cheuck	29	President, Metrowerks Co., Ltd., Japanese Subsidiary
Dave Mark	39	Vice President, Discover/Academic Products
James Walker	28	Vice President, Operations
Jim Welch	31	Vice President, Finance & Chief Financial Officer

Jean Bélanger became Chairman of Metrowerks in 1989 and joined the Company full-time in that capacity in 1991. Mr. Bélanger earned an M.Sc. (Finance) from the London School of Economics and a B.Comm. from the University of Ottawa, and is a Chartered Accountant. Mr. Bélanger is located in Austin, Texas.

Greg Galanos founded Metrowerks in 1985. Mr. Galanos is President and Chief Technology Officer of the Company. Mr. Galanos oversees the Company's research and development efforts. Mr. Galanos earned an M.Sc. (Computer Science) from the University of Quebec at Montreal. Mr. Galanos is located in Cupertino, California.

David Perkins joined Metrowerks in May 1995, as Vice President, Finance and Chief Financial Officer. Mr. Perkins was appointed Senior Vice President, Sales and Business Development in 1997. Prior to joining Metrowerks, Mr. Perkins was an audit partner with Coopers & Lybrand. Mr. Perkins earned a B.Comm. from McGill University and is a Chartered Accountant. Mr. Perkins is located in Austin, Texas.

Berardino Baratta is Vice President, Research and Development. Mr. Baratta joined Metrowerks in 1992 and played an essential role in the early stages of development of CodeWarrior development tools, the Company's flagship product line. Mr. Baratta earned a B.Eng. from McGill University. Mr. Baratta is located in Austin, Texas.

John H.M. Cheuck is President, Metrowerks Co., Ltd. (Tokyo) and leads the company's efforts in the Asian region with a focus on the Japanese market. Mr. Cheuck holds a B.A.Sc. (Systems Design Engineering) from the University of Waterloo and an M.B.A. from the Japan America Institute of Management Science/University of Hawaii. Mr. Cheuck is located in Tokyo, Japan.

Dave Mark is Vice President, Discover/Academic Products. Mr. Mark joined Metrowerks in 1995. Mr. Mark has written more than a dozen books on programming and programming-related topics. He has a BS (Math) from Carnegie-Mellon University and an M.Sc. in Computer Science and Computer Engineering from Stanford University. Mr. Mark is located in Washington, DC.

James Walker is Vice President, Operations. Prior to joining Metrowerks in January 1997, Mr. Walker was a Manager with Price Waterhouse in Dallas. He is a CPA and earned his B.S. from Kansas State University. Mr. Walker is located in Austin, Texas.

Jim Welch is Vice President, Finance and Chief Financial Officer. Before joining Metrowerks in June 1996, Mr. Welch was a Senior Manager at Coopers & Lybrand in Austin. He is a CPA and earned his B.B.A. from The University of Texas at Austin. Mr. Welch is located in Austin, Texas.

Item 11. Executive Compensation

The following table sets forth certain summary information concerning the compensation awarded to, earned by, or paid for services rendered to the Company in all capacities during the fiscal years ended July 31, 1997, 1996, and 1995 by the Company's Chief Executive Officer and the four most highly compensated executive officers other than the Chief Executive Officer, collectively the "Named Executive Officers."

Name	Year	Salary (US\$)	Bonus (US\$)	Other Annual Compensation Granted	Securities Under Options Share Units (US\$)
Jean Bélanger,	1997	118,615	0	0	15,000
Chairman of the Board	1996	106,498	0	0	0
& CEO	1995	100,868	0	0	0
Greg Galanos,	1997	118,615	0	0	15,000
President &	1996	106,498	0	0	15,000
Chief Technology Officer	1995	100,868	0	0	15,000
David Perkins,	1997	118,615	0	0	20,500 ⁽¹⁾
Senior VP, Sales &	1996	106,498	0	0	15,000
Business Development	1995 ⁽¹⁾	25,000	0	0	50,000
John Cheuck, President,	1997 ⁽²⁾	146,667	0	27,500	30,000 ⁽³⁾
Metrowerks Co., Ltd.					
Dave Mark, Vice President,	1997	80,000	40,000	0	8,500 ⁽³⁾
Discover/Academic Products	1996 ⁽³⁾	63,333	25,000	0	32,500

(1) Three month period

(2) Eleven month period.

(3) Eleven month period.

(4) 7,500 of these options were originally granted in the financial year ended July 31, 1996 at an exercise price of US\$12.20 (C\$17.00) and were repriced during the financial year ended July 31, 1997 by reducing the exercise price to US\$7.00 (C\$9.75). The remainder of these options were granted at an exercise price of US\$10.70 (C\$14.90) (as to 5,500) and at an exercise price of US\$8.50 (C\$11.85) (as to 7,500) and were repriced by reducing the exercise price to US\$7.00 (C\$9.75) during the financial year ended July 31, 1997.

(5) These options were granted at an exercise price of US\$10.70 (C\$14.90) and were repriced by reducing the exercise price to US\$7.00 (C\$9.75) in both cases during the financial year ended July 31, 1997.

(6) 3,500 of these options were granted at an exercise price of US\$10.70 (C\$14.90) and were repriced by reducing the exercise price to US\$7.00 (C\$9.75) in both cases during the financial year ended July 31, 1997.

OPTIONS GRANTED DURING THE MOST RECENTLY COMPLETED FINANCIAL YEAR

For the purposes herein, a change in the exercise price of an outstanding option is considered to be a grant of a new option. Accordingly, the following table sets forth the individual grant of stock options as well as grants resulting from the repricing of certain stock options which occurred during the fiscal year ending July 31, 1997 to the Named Executive Officers.

Name	Securities Under Options Granted (#) ⁽¹⁾	% of Total Options Granted to Employees in Financial Year ⁽²⁾	Exercise or Base Price (US\$/Security)	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Terms ⁽⁵⁾	
					5% \$US	10% \$US
Jean Bélanger	7,500	0.9	11.75	Sept. 16/01	24,347	53,801
	7,500	0.9	9.35	Feb. 14/02	19,374	42,812
Greg Galanos	7,500	0.9	11.75	Sept. 16/01	24,347	53,801
	7,500	0.9	9.35	Feb. 14/02	19,374	42,812
David Perkins	7,500 ⁽³⁾	0.9	7.00	June 6/01	14,505	32,052
	5,500 ⁽⁴⁾	0.7	7.00	Sept. 16/01	10,637	23,505
	7,500 ⁽³⁾	0.9	7.00	Feb. 14/02	14,505	32,052
John Cheuck	30,000 ⁽⁴⁾	3.6	7.00	Sept. 16/01	58,019	128,207
Dave Mark	3,500 ⁽⁴⁾	0.4	7.00	Sept. 16/01	6,769	14,957
	5,000	0.6	5.06	April 24/02	6,990	15,446

(1) Options granted are for common stock of the Company. These Options vest at the rate of one-third per year after each of the three years following the grant. The Options have a maximum term of 5 years. No financial assistance is provided by the Company for the purchase of common stock on the exercise of options.

(2) Based on total option grants/repricings of 837,050.

(3) Granted in fiscal 1996 and repriced in fiscal 1997.

(4) Granted and repriced in fiscal 1997.

(5) Potential realizable value is based on the assumption that common stock of the Company appreciated the annual rate shown (compounded annually) from the date of grant until the expiration of the five-year term. These numbers are calculated based on Securities and Exchange Commission requirements and do not reflect the Company's estimate of future price growth.

AGGREGATED OPTION EXERCISES DURING THE MOST RECENTLY COMPLETED FINANCIAL YEAR AND FINANCIAL YEAR-END OPTION VALUES

The following table sets forth the total number of securities underlying unexercised options of the Named Executive Officers and their dollar value during the financial year ended July 31, 1997 to the Named Executive Officers exercised stock options during the fiscal year ended July 31, 1997.

Name	Securities Acquired on Exercise (#)	Aggregate Value Realized (\$)	Unexercised Options at FY-End (#)		Value of Unexercised in-the-Money Options at FY-End (1)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Jean Bélanger	0	N/A	0	15,000	0	0
Greg Galanos	0	N/A	0	15,000	0	0
David Perkins	0	N/A	55,000	23,000	US\$239,080 (C\$332,750)	US\$14,600 (C\$20,500)
John Cheuck	0	N/A	0	30,000	0	0
Dave Mark	0	N/A	10,833	30,167	US\$31,912 (C\$44,415)	US\$72,450 (C\$100,835)

(1) Based on a closing stock price of US\$6.70 (C\$9.35) per common stock on July 31, 1997, the last day the common stock were traded prior to the Company's 1997 financial year end.

STOCK OPTION PLAN

The current stock option plan of the Company (the "Plan") was adopted by the Board of Directors on June 21, 1995, was approved by the shareholders of the Company at the annual general meeting of shareholders held on October 26, 1995 and was amended by resolution of the shareholders of the Company at the annual and special meeting of shareholders held on October 28, 1996 to increase the number of Shares reserved for issuance under the Plan by 1,000,000 Shares to 2,600,000 Shares. The Plan will terminate in June, 2005. As of July 31, 1997, there were currently outstanding under the Plan options to purchase a total of 1,166,267 Shares, representing approximately 9% of the issued and outstanding Shares on a fully-diluted basis.

The Plan provides that options may be granted to the Company's employees, officers, directors, or consultants, based on the eligibility criteria set out in the Plan. Under the Plan, the Company may grant either ISOs or Non-ISOs. An ISO is defined in the Plan as an "incentive stock option", as such term is defined in section 422 of the United States Internal Revenue Code of 1986, as amended from time to time (the "Code") and is therefore subject to favorable tax treatment under the Code. A Non-ISO is defined in the Plan as a stock option that is not an ISO and is therefore not subject to favorable tax treatment under the Code.

The options issued pursuant to the Plan will be exercisable at a price which is equal to the fair market value of the shares at the time the option is granted. So long as the Company is listed on a stock exchange or over the counter market and the optionee does not own more than 10% of the total voting power of all classes of shares of the Company or an affiliate of the Company, fair market value will be determined as the closing market price for the Shares of the Company on the Canadian stock exchange which is the principal trading market for the Shares, as determined by the Committee, on the day immediately preceding the date of grant.

Options under the Plan are granted for a term not to exceed ten years, but generally have five year terms from the date of their grant and subject to certain exceptions in the Plan relating to the death or disability of the Optionee, the options are non-assignable and non-transferable. The Committee has full discretion to impose a vesting schedule on the options issued pursuant to the Plan.

EMPLOYMENT CONTRACTS AND CHANGE-IN-CONTROL ARRANGEMENTS

The Company currently has no employment contracts with any Named Executive Officers. The Company also has no compensatory plans or arrangements with such Named Executive Officers where the amounts to be paid exceed \$100,000 and which are activated upon resignation, termination, retirement or upon a change in control of the Company.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

Mr. Galanos serves on the Compensation Committee for the Board and is President and Chief Technology Officer of the Company. Mr. Galanos does not participate in any decisions regarding his compensation.

COMPENSATION OF DIRECTORS

Directors of the Company are able to participate in the Company's Stock Option Plan. To date, outside directors have been granted 5,000 options each. The directors are also reimbursed for their reasonable expenses in attending the meetings of the Board.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The following table sets forth certain information regarding the beneficial ownership of Common Stock of the Company as of July 31, 1997 as to (i) each person who is known by the Company to own beneficially more than 5% of the outstanding shares of Common Stock, (ii) each director of the Company (iii) each of the Named Executive Officers (as defined above) and (iv) all directors and officers as a group.

Name of Shareholder	Number of Shares	Percentage Ownership ^{(1) (2)}
Jean Bélanger ⁽³⁾	1,980,239	17.2 %
Greg Galanos ⁽⁴⁾	1,980,239	17.2 %
Stephen Lockyer ⁽⁵⁾	506,517	4.4 %
Geoff Beattie ⁽⁶⁾	5,667	*
Tom Woods ⁽⁷⁾	3,667	*
David Perkins ⁽⁸⁾	91,833	*
Dave Mark ⁽⁹⁾	12,000	*
John Cheuck ⁽¹⁰⁾	10,000	*
All executive officers as a group (10 persons) ⁽¹¹⁾	4,607,528	39.4 %

*Less than 1% of the Company's outstanding common stock

- (1) Applicable percentage ownership is based on 11,537,500 shares of common stock outstanding as of July 31, 1997 together with applicable options for such stockholder. Beneficial ownership is determined in accordance with rules of the Securities and Exchange Commission (the "SEC") and includes voting and investment power with respect to shares. Shares of common stock subject to options currently exercisable or exercisable within 60 days after July 31, 1997 are deemed outstanding for computing the percentage ownership of the person holding such options, but are not deemed outstanding for computing the percentage of any other person.
- (2) This table is based upon information supplied by officers, directors and principal stockholders and Schedules 13G filed with the SEC. Unless otherwise indicated in the footnotes to this table and subject to community property laws where applicable, the Company believes that each of the stockholders named in this table has sole voting and investment power with respect to the shares indicated as beneficially owned.
- (3) Includes 2,500 shares subject to options exercisable within 60 days of July 31, 1997. Mr. Bélanger is Chairman and Chief Executive Officer of the Company. Mr. Bélanger's address is c/o Metrowerks Inc., 2201 Donley Dr., Suite 310, Austin, TX 78758.
- (4) Includes 2,500 shares subject to options exercisable within 60 days of July 31, 1997. Mr. Galanos is President and Chief Technology Officer of the Company. Mr. Galanos' address is c/o Metrowerks Inc., 2201 Donley Dr., Suite 310, Austin, TX 78758.
- (5) Includes 1,667 shares subject to options exercisable within 60 days of July 31, 1997. Mr. Lockyer is a director of the Company.
- (6) Includes 1,667 shares subject to options exercisable within 60 days of July 31, 1997. Mr. Beattie is a director of the Company.
- (7) Includes 1,667 shares subject to options exercisable within 60 days of July 31, 1997. Mr. Woods is a director of the Company.
- (8) Includes 61,833 shares subject to options exercisable within 60 days of July 31, 1997. Mr. Perkins is the Company's Vice President, Sales and Business Development.
- (9) All shares are subject to options exercisable within 60 days of July 31, 1997. Mr. Mark is the Company's Vice President, Discover and Academic Products.
- (10) All shares are subject to options exercisable within 60 days of July 31, 1997. Mr. Cheuck is President, Metrowerks Co. Ltd.
- (11) Includes an additional 17,366 shares subject to options exercisable within 60 days of July 31, 1997, held by executive officers not otherwise listed in this table.

Item 13. Certain Relationships and Related Transactions

Mr. Geoff Beattie, a director of the Company, is a partner in the law firm of Tory Tory DesLauriers & Binnington of Toronto, which was retained by the Company during its last fiscal year. Total fees paid by the Company to the firm did not exceed five percent of such law firm's gross revenues for such law firm's last full fiscal year.

Item 14. Exhibits, Financial Statement Schedules
and Reports on 8-K

(a) The following documents are filed as part of this report

(1) Consolidated Financial Statements - See "Index to Consolidated Financial Statements" on F-1

(2) Consolidated Financial Statement Schedule - See "Index to Consolidated Financial Statements" on F-1

(3) Exhibits

The following exhibits are filed herewith:

Exhibit Number	Exhibit Title
3.1	Amended Articles of Incorporation of the Company
3.2	By-Laws of Metrowerks
10.1	Incentive Stock Option Plan and related agreements
10.2	1995 Stock Option Plan and related agreements
10.3	Lease agreement between the Company and Modular Power Facilities Limited Partnership
10.4	401(K) Plan of the Company
11	Statement Regarding Computation of Per Share Earnings
21	List of Subsidiaries
27	Financial Data Schedule

(b) Reports on Form 8-K -

None

METROWERKS INC. AND SUBSIDIARIES
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Consolidated Financial Statements:

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Consolidated Balance Sheets as of July 31, 1995, 1996 and 1997 F-3

Consolidated Statements of Operations for the years
ended July 31, 1995, 1996 and 1997 F-4

Consolidated Statements of Changes in Stockholders' Equity for the years
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Report of Independent Accountants S-1

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All other schedules are omitted as the required information is not applicable or the information is presented in the consolidated financial statements, related notes, or other schedules.

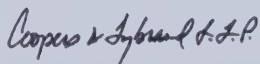
REPORT OF INDEPENDENT ACCOUNTANTS

To the Stockholders of
Metrowerks Inc.

We have audited the accompanying consolidated balance sheets of Metrowerks Inc. and Subsidiaries (the "Company") as of July 31, 1995, 1996 and 1997, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of July 31, 1995, 1996 and 1997, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States and Canada.



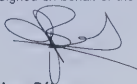
COOPERS AND LYBRAND L.L.P.

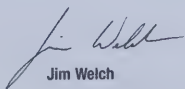
Austin, Texas
August 25, 1997

METROWERKS INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS, EXCEPT SHARE AMOUNTS)

ASSETS	1995	1996	1997
Current assets:			
Cash and cash equivalents	\$ 4,746	\$ 11,498	\$ 5,042
Accounts receivable, net	560	2,838	5,027
Inventories	64	254	302
Income and other taxes recoverable	237	224	295
Prepaid expenses and other current assets	198	573	456
Total current assets	5,805	15,387	11,122
Property and equipment, net (Note 3)	357	1,716	3,046
Software development costs, net of accumulated amortization of \$83, \$358 and \$-0-, respectively	472	1,202	-
Total assets	\$ 6,634	\$ 18,305	\$ 14,168
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Accounts payable	\$ 493	\$ 1,129	\$ 1,913
Accrued liabilities (Note 4)	487	550	1,498
Deferred revenue	83	189	195
Total current liabilities	1,063	1,868	3,606
Commitments (Note 7)	-	-	-
Stockholders' equity:			
Capital stock (Note 5)			
Preferred stock, Class A and B, no par value, unlimited as to number; none outstanding			
Common Stock, no par value, unlimited as to number; 11,537,500 shares issued and outstanding (1996-11,496,983; 1995-8,177,233)	2,221	17,446	17,596
Special Warrants, none issued (1995-2,000,000; 1996-0)	4,464	-	-
Accumulated deficit	(1,114)	(1,009)	(6,984)
Cumulative translation adjustment	-	-	(50)
Total stockholders' equity	5,571	16,437	10,562
Total liabilities and stockholders' equity	\$ 6,634	\$ 18,305	\$ 14,168

Signed on behalf of the Board of Directors


Jean Bélanger
Director


Jim Welch
Vice President, Finance
& Chief Financial Officer

METROWERKS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS, EXCEPT PER SHARE AMOUNTS)

	1995	1996	1997
Revenue, net (Note 10)	\$ 5,143	\$ 10,619	\$ 18,293
Cost of sales (Note 1)	910	2,664	4,563
Operating expenses			
Research and development	1,574	3,250	6,486
Selling, administrative and technical support	2,348	4,622	8,109
Depreciation of property and equipment	155	355	1,154
Non-recurring charge (Note 2)	—	—	4,297
Total operating expenses	4,077	8,227	20,046
Earnings (loss) from operations	156	(272)	(6,316)
Other income:			
Interest income and other	98	377	341
Net earnings (loss)	\$ 254	\$ 105	\$ (5,975)
Net earnings (loss) per common and common equivalent share	\$ 0.03	\$ 0.01	\$ (0.52)
Weighted average number of common shares and common equivalent shares outstanding	7,956	10,620	11,523

The accompanying notes are an integral part of these consolidated financial statements.

METROWERKS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS, EXCEPT SHARE AMOUNTS)

	Common Stock		Special Warrants		Accumulated Deficit	Cumulative Translation Adjustment	Total Stockholders' Equity
	Shares	Amount	Shares	Amount			
Balance at August 1, 1994	7,823,433	\$ 1,855	—	\$ —	\$ (1,368)	\$ —	\$ 487
Issuance of common stock	353,800	366	—	—	—	—	366
Issuance of special warrants	—	—	2,000,000	4,464	—	—	4,464
Net earnings	—	—	—	—	254	—	254
Balance at July 31, 1995	8,177,233	2,221	2,000,000	4,464	(1,114)	—	5,571
Conversion of special warrants	2,000,000	4,464	(2,000,000)	(4,464)	—	—	—
Issuance of common stock	1,319,750	10,761	—	—	—	—	10,761
Net earnings	—	—	—	—	105	—	105
Balance at July 31, 1996	11,496,983	17,446	—	—	(1,009)	—	16,437
Issuance of common stock	40,517	150	—	—	—	—	150
Foreign currency translation adjustment	—	—	—	—	—	(50)	(50)
Net loss	—	—	—	—	(5,975)	—	(5,975)
Balance at July 31, 1997	11,537,500	\$ 17,596	—	\$ —	\$ (6,984)	\$ (50)	\$ 10,562

The accompanying notes are an integral part of these consolidated financial statements.

METROWERKS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS)

	1995	1996	1997
Cash flows from operating activities:			
Net earnings (loss)	\$ 254	\$ 105	\$ (5,975)
Adjustments to reconcile net earnings (loss) to net cash provided by (used in) operating activities:			
Depreciation of property and equipment	155	355	1,154
Amortization of software development costs	83	275	289
Loss on sale of property and equipment	4	—	—
Non-recurring charge (Note 2)	—	—	4,297
Changes in assets and liabilities:			
Accounts receivable	(246)	(2,278)	(3,911)
Inventories	(54)	(190)	(406)
Income and other taxes receivable	(142)	13	(71)
Prepaid expenses and other assets	(116)	(375)	117
Accounts payable	323	521	685
Accrued liabilities	420	63	948
Deferred revenue	83	106	6
Net cash provided by (used in) operating activities	764	(1,405)	(2,867)
Cash flows from investing activities:			
Additions to property and equipment	(296)	(1,599)	(2,385)
Software development costs capitalized	(422)	(1,005)	(833)
Proceeds on sale of property and equipment	90	—	—
Acquired in-process research and development	—	—	(471)
Net cash used in investing activities	(628)	(2,604)	(3,689)
Cash flows from financing activities:			
Net proceeds from issue of common stock net of issuance costs of \$1,504 in 1996	—	10,341	—
Net proceeds from issue of special warrants	4,464	—	—
Proceeds from exercise of stock options	366	420	150
Repayment of long-term debt	(987)	—	—
Foreign currency translation adjustment	—	—	(50)
Net cash provided by financing activities	3,843	10,761	100
Increase (decrease) in cash and cash equivalents	3,979	6,752	(6,456)
Cash and cash equivalents at beginning of year	767	4,746	11,498
Cash and cash equivalents at end of year (Note 1)	\$ 4,746	\$ 11,498	\$ 5,042
Non-cash investing and financing activities:			
Accrued property and equipment	\$ 19	\$ 115	\$ 99

The accompanying notes are an integral part of these consolidated financial statements.

1. Summary of Significant Accounting Policies:

Basis of Presentation

These financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States ("US GAAP") and in Canada ("Canadian GAAP").

Basis of Consolidation

The consolidated financial statements include the accounts of the Company and its two wholly-owned subsidiaries, Metrowerks Corporation, a Texas corporation, which was formed in June 1994, and Metrowerks Co. Ltd., a Japanese corporation, which was formed in October 1996. All significant intercompany transactions and balances have been eliminated.

Revenue Recognition

Product revenue, which consists of sales to distributors and from corporate license programs, is recognized when the related products are shipped, when no significant vendor obligations remain, and collection of the receivable, net of provisions for estimated future returns, is probable. The allowance for estimated future returns was \$248, \$275 and \$1,192 at July 31, 1995, 1996 and 1997, respectively. Allowances for estimated future software updates are provided for in the same period as the related revenue. The allowance at July 31, 1997 includes approximately \$917 from the provision for promotional and inventory related costs taken in the quarter ended April 30, 1997 (see Note 2).

Product development agreement revenue is recognized on a percentage of completion basis.

Cost of Sales

Cost of sales consists primarily of the cost of product media and duplication, the cost of packaging materials, amortization of capitalized research and development costs, royalties and shipping expenses. Cost associated with product development agreement revenues are included in research and development expenses and are not separately identified and approximate revenue.

Cash and Cash Equivalents

The Company considers investments in highly liquid instruments purchased with original maturities of 90 days or less to be cash equivalents. All of the Company's cash equivalents consist principally of government guaranteed instruments and are reported at cost which approximates fair market value.

Credit Risk

The Company performs ongoing credit reviews of all its customers and records an allowance for doubtful accounts receivable when accounts are determined to be uncollectible. The allowance for doubtful accounts at July 31, 1995, 1996 and 1997 was \$9, \$9 and \$75, respectively.

METROWERKS INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED
JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS)

1. Summary of Significant Accounting Policies, continued:

Inventories

Inventories, consisting of product documentation, magnetic media and hardware are stated at the lower of cost or net realizable value. Cost is determined using the average cost method.

Software Development Costs

Research and development expenditures are charged to operations as incurred. The Company capitalizes certain software development costs subsequent to the establishment of technological feasibility, if material. In addition, the Company periodically reviews its software development costs to access net realizable value. Any impairments are recognized in operating results when a permanent diminution in value occurs. Based on the Company's product development process, technological feasibility is established upon completion of a working model. In fiscal 1997, costs incurred by the Company between completion of the working model and the point at which the product is ready for general release have been insignificant.

For the years ended July 31, 1995, 1996 and 1997, amortization expense amounted to \$83, \$275 and \$289, respectively.

Research and software development costs are reduced by investment tax credits.

Property and Equipment

Purchased property and equipment is recorded at cost. Depreciation is provided using the straight-line method over the estimated useful lives of the respective assets as follows:

Office equipment	5 years
Computer equipment	2-5 years
Software	3 years

The Company provides for depreciation of leasehold improvements over the term of the related lease. Expenditures for maintenance and repairs are expensed as incurred. Upon retirement or other disposition of assets, the cost and related accumulated depreciation are eliminated from the accounts and the resulting gain or loss is reflected in operations.

Deferred Revenue

Deferred revenue consists of amounts received in advance for product, documentation, magnetic media and development services to be delivered in future periods.

METROWERKS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS)

1. Summary of Significant Accounting Policies, continued:

Foreign Currency Translation

The financial statements of the parent company and its non-U.S. subsidiaries have been translated into U.S. dollars in accordance with the FASB Statement No. 52, "Foreign Currency Translation." Monetary asset and liability amounts have been translated using the exchange rates in effect at the applicable year end. Inventories, property, and non-monetary asset and liability amounts have been translated at historical exchange rates. Income statement amounts have been translated using the weighted average exchange rate for the applicable year. The gains and losses resulting from the changes in exchange rates from year to year have been reported as a separate component of Stockholders' Equity. Currency transaction gains or losses are immaterial for all periods presented.

Effective August 1, 1995, the Company changed its reporting currency from Canadian dollars to U.S. dollars. The consolidated financial statements at July 31, 1995 have been restated as if the U.S. dollar had always been the currency of measurement.

Federal Income Taxes

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." This method requires that deferred taxes be computed annually utilizing the liability method and adjusted when new tax laws or rates are enacted. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized. The Company recorded no income tax expense in 1995, 1996 or 1997, and has provided a full valuation allowance to reduce the net deferred tax asset to \$-0- because the realization of tax benefits associated with net operating loss carryforwards is not assured (see Note 9).

Advertising Costs

Advertising costs are expensed as incurred. For the years ended July 31, 1995, 1996 and 1997, advertising expense amounted to \$498, \$1,179 and \$1,865, respectively. Advertising expense consists of costs from catalog advertising, trade journal advertising, mass mailings and various other promotional items.

Net Earnings (Loss) Per Common Share

The net earnings (loss) per common share is calculated by using the weighted average number of common shares and common share equivalents outstanding during the year.

Fair Value of Financial Instruments

The Company's financial instruments as defined by SFAS No. 107, "Disclosures about Fair Value of Financial Instruments," include cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities, and are accounted for on a historical cost basis, which, due to the nature of these financial instruments approximates fair value at July 31, 1995, 1996 and 1997.

METROWERKS INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS)

1. Summary of Significant Accounting Policies, continued:

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Reclassifications

Certain prior year financial statement items have been reclassified to conform to the current year presentation.

2. Non-Recurring Charge:

The Company recorded a non-recurring charge of \$4,297 for the quarter ended April 30, 1997 related to the write-off of certain assets associated with Apple Computer's Macintosh Operating System ("Mac OS"). The decision to record this charge was based on the significant decline in sales of Mac OS related products. The Company had accelerated its diversification efforts to focus on the Windows and embedded systems markets and believed that the Mac OS related assets were significantly impaired.

The components of the write-off were as follows:

Software development costs	\$ 1,746
Provision for promotional and inventory related costs	1,722
Write-off of inventories	358
Acquired in-process research and development	471
Total	<u>\$4,297</u>

The \$1,746 write-off of software development costs relates to previously capitalized Mac OS IDE development costs. The provision for accounts receivable primarily relates to promotional costs in assisting distributors and retail outlets in selling Mac OS related products already existing in the distribution channel. The write-off of inventories relates to Mac OS inventory on-hand as of quarter ended April 30, 1997. The write-off of acquired in-process research and development relates to the purchase of substantially all of the assets of a software company. The assets of the software company acquired will be developed to assist in porting Mac OS applications to Apple's next generation operating system, Rhapsody. At the time of acquisition, technological feasibility had not been reached.

METROWERKS INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED
JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS)

3. Property and Equipment:

Property and equipment consist of the following:

	July 31, 1995		
	Cost	Accumulated Amortization	Net
Office equipment	\$ 63	\$ 20	\$ 43
Computer equipment	440	170	270
Software	60	18	42
Leasehold improvements	7	5	2
	<u>\$ 570</u>	<u>\$ 213</u>	<u>\$ 357</u>

	July 31, 1996		
	Cost	Accumulated Amortization	Net
Office equipment	\$ 464	\$ 62	\$ 402
Computer equipment	1,288	403	885
Software	505	91	414
Leasehold improvements	17	2	15
	<u>\$ 2,274</u>	<u>\$ 558</u>	<u>\$ 1,716</u>

	July 31, 1997		
	Cost	Accumulated Amortization	Net
Office equipment	\$ 1,336	\$ 265	\$ 1,071
Computer equipment	2,372	1,077	1,295
Software	798	306	492
Leasehold improvements	275	87	188
	<u>\$ 4,781</u>	<u>\$ 1,735</u>	<u>\$ 3,046</u>

4. Accrued Liabilities:

	1995	1996	1997
Accrued compensation and related costs	\$ 93	\$ 241	\$ 550
Professional fees	302	115	250
Provision for costs of software updates	67	59	169
Royalties	—	47	113
Other	25	88	416
	<u>\$ 487</u>	<u>\$ 550</u>	<u>\$ 1,498</u>

METROWERKS INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED
JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS, EXCEPT SHARE AMOUNTS)

5. Capital Stock:

Preferred Stock

The Class A preferred shares are non-voting, non-cumulative preferred shares, redeemable at the option of the Company or the holder at their stated amount. Dividends on Class A shares, having priority over all other classes of shares may be paid at the discretion of the Board of Directors up to a maximum of 10% of the stated capital.

The terms of the Class B preferred shares will be determined by the Board of Directors at the time of issuance of the shares.

As of July 31, 1997, there were no issued Class A or Class B preferred shares.

Stock Option Plan

The Company maintains an incentive stock option plan ("Plan") for the benefit of directors, officers and employees. The exercise price of the incentive stock option is the fair market value of the shares as at the date of the grant. Stock options generally become vested ratably over a three-year period.

Stock options outstanding were as follows:

	Options	Weighted-average Exercise Price	Weighted-average Fair Value Granted During the Period
Outstanding and exercisable balance at August 1, 1994	497,000	\$ 1.53	
Granted	348,750	2.66	\$ —
Exercised	(153,800)	2.15	
Canceled	(79,000)	1.61	
Outstanding and exercisable balance at July 31, 1995	612,950	2.15	
Granted	443,050	9.64	3.00
Exercised	(317,250)	1.83	
Canceled	(124,600)	5.65	
Outstanding and exercisable balance at July 31, 1996	614,150	7.01	
Granted	758,500	9.49	1.80
Exercised	(40,517)	3.70	
Canceled	(165,866)	8.50	
Outstanding and exercisable balance at July 31, 1997	1,166,267		

METROWERKS INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED
JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS, EXCEPT PER SHARE AMOUNTS)

5. Capital Stock, continued:

Stock Option Plan, continued

The Company has applied Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, in accounting for the Plan. Accordingly, no compensation expense has been recognized for the Plan. Had compensation cost for the Plan been determined based upon the fair value at the grant date for awards under the Plan consistent with the methodology prescribed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," and the Company's net earnings (loss) would have changed to the pro forma amounts, indicated below:

	July 31, 1996	July 31, 1997
Net earnings (loss) - as reported	\$ 105	\$ (5,975)
Net earnings (loss) - pro forma	(189)	(6,435)
Net earnings (loss) per share - as reported	0.01	(0.52)
Net earnings (loss) per share - pro forma	(0.02)	(0.56)

The fair value of each option grant is estimated on the date of grant using an option-pricing model, the Black-Scholes model, with the following weighted average assumptions: dividend yield of 0.0%, risk-free interest rate of 6.06%, expected life of three years and volatility of 53.00%.

The following table summarizes information about fixed stock options outstanding at July, 31, 1997:

Range of Excessive Prices	Options Outstanding and Exercisable	
	Number Outstanding and Exercisable at July 31, 1997	Weighted-Average Remaining Contractual Life
\$ 3.78 - \$ 13.14	408,267	4.3 years
\$ 5.06 - \$ 10.70	758,000	4.7 years
	1,166,267	

On July 17, 1997, the Company repriced 618,500 options to a price equal to 110% of the then market value. These options were repriced from a range of between \$8.50 and \$13.14 to \$7.00.

6. Employee Benefits:

In January 1996, the Company established a 401(k) retirement savings plan (the "Plan") for all employees. All employees meeting minimum age requirements are eligible to enroll in the Plan after 250 hours of employment. The Company did not provide matching contributions to employee accounts for the years ended July 31, 1995, 1996 and 1997.

METROWERKS INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED
JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS)

7. Commitments:

The Company leases various facilities under noncancelable operating leases. Future minimum lease payments required under operating leases that have initial or remaining noncancelable lease terms in excess of one year as of July 31, 1997 are as follows:

1998	\$ 465
1999	237
2000	101
2001	7
	<hr/>
	\$ 810

Total rent expense for noncancelable operating leases was \$69, \$139 and \$422 for the years ended July 31, 1995, 1996 and 1997, respectively.

The Company engages the services of individual contractors to assist in research and development related to the Company's software products.

8. Risks and Uncertainties:

The Company has accounts receivable in excess of 10% of its total accounts receivable with one unrelated party, Ingram Micro Inc. (a major distributor), for the year ended July 31, 1997, aggregating approximately \$2,146 (34% of total accounts receivable). Historically, the Company has not incurred any bad debt expense in connection with any transactions with Ingram Micro Inc. Additionally, the Company had sales in excess of 10% of its net sales to Ingram Micro Inc. for the year ended July 31, 1997, aggregating approximately \$3,050 (15.6% of total sales).

9. Income Taxes:

The components of the deferred tax assets are as follows at July 31:

	1995	1996	1997
Deferred tax assets:			
Net operating loss carryforwards	\$ 273	\$ 272	\$ 2,043
Property and equipment	12	30	178
Reserves	10	120	546
Investment tax credit	160	98	270
Other	(33)	(119)	46
Net deferred tax asset before valuation allowance	422	401	3,083
Valuation allowance	(422)	(401)	(3,083)
	<hr/>	<hr/>	<hr/>
Net deferred tax asset	\$ -	\$ -	\$ -

Net operating loss carryforwards of \$4,670 expire 2000 through 2002.

METROWERKS INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED
JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS)

9. Income Taxes, continued:

The difference between the actual income tax provision computed by applying the statutory income tax rate to earnings (loss) before taxes is attributed to the following:

	1995 %	1996 %	1997 %
Statutory tax rate	37.86	38.01	38.00
Future benefit of timing differences not recognized	(30.04)	(43.12)	(39.40)
Permanent differences	(7.82)	5.11	1.40

10. Revenue:

Revenue is comprised of the following:

Revenue	1995	1996	1997
Product	\$ 4,044	\$ 7,246	\$ 12,254
Product development agreement	613	2,263	4,715
Hardware and other	486	1,110	1,324
	\$ 5,143	\$ 10,619	\$ 18,293

11. Geographic Data:

The Company's revenues by geographic location are as follows:

Revenue	1995	1996	1997
United States	\$ 4,029	\$ 8,583	\$ 13,685
Canada	258	156	243
Japan	512	851	2,596
European Union	235	723	1,452
Other	109	306	317
	\$ 5,143	\$ 10,619	\$ 18,293

METROWERKS INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, CONTINUED
JULY 31, 1995, 1996 AND 1997
(U.S. THOUSANDS OF DOLLARS)

11. Geographic Data, continued:

The Company's assets by geographic location are as follows:

	1995	1996	1997
United States	\$ 270	\$ 4,466	\$ 8,183
Canada	6,376	17,990	17,366
Japan	—	—	1,024
Intercompany eliminations	(12)	(4,151)	(12,405)
	\$ 6,634	\$ 18,305	\$ 14,168

12. Recent Pronouncements:

In February 1997, the the Financial Accounting Standards Board ("FASB") issued SFAS No. 128, "Earnings Per Share" which establishes standards for computing and presenting earnings per share. SFAS No. 128 is effective for fiscal years ending after December 15, 1997. Management does not believe the implementation of SFAS No. 128 will have a material effect on its consolidated financial statements.

In February 1997, the FASB issued SFAS No. 129, "Disclosure of Information About Capital Structure" which establishes disclosure requirements for an entity's capital structure. SFAS No. 129 is effective for fiscal years periods ending December 15, 1997. Management does not believe the implementation of SFAS No. 129 will have a material effect on its consolidated financial statements.

In June 1997, the FASB issued SFAS No. 130, "Reporting Comprehensive Income," which establishes standards for reporting and display of comprehensive income and its components in a full set of general-purpose financial statements. SFAS No. 130 is effective for fiscal years beginning after December 15, 1997.

Also in June 1997, the FASB issued SFAS No. 131, "Disclosures about Segments of an Enterprise and Restated Information," and the Canadian Institute of Chartered Accountants (CICA) issued Section 1701, which establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports issued to shareholders. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. SFAS No. 131 is effective for financial statements for periods beginning after December 15, 1997.

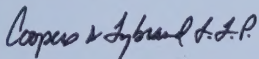
Management does not believe the implementation of SFAS No. 130 and No. 131 will have a material effect on its financial statements.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Stockholders of
Metrowerks Inc. and Subsidiaries

Our report on the consolidated financial statements of Metrowerks Inc. and subsidiaries is included on page F-2 of this Form 10-K. In connection with our audits of such financial statements, we have also audited the consolidated financial statement schedule listed in the index on page F-1 of this Form 10-K herein.

In our opinion, the financial statements referred to above, when considered in relation to the basic financial statements taken as a whole, present fairly, in all material respects, the information required to be included therein.



COOPERS & LYBRAND L.L.P.

Austin, Texas
August 25, 1997

METROWERKS INC. AND SUBSIDIARIES
 SCHEDULE II.
 VALUATION AND QUALIFYING ACCOUNTS
 (U.S. THOUSANDS OF DOLLARS)

Description	Balance at Beginning of Period	Charged to Costs and Expenses	Deductions	Balance at End of Period
Allowance for doubtful accounts and returns				
1995	\$ 146	\$ 458	\$ 347	\$ 257
1996	257	901	874	284
1997	284	2,623	1,640	1,267

METROWERKS INC.

BOARD OF DIRECTORS & OFFICERS

Board of Directors

Gregory Galanos
President & Chief Technology Officer
Cupertino, California

Jean Bélanger
Chairman & Chief Executive Officer
Austin, Texas

David Perkins
Senior VP, Sales & Business Development
Austin, Texas

Geoff Beattie
Partner, Tory Tory DesLauriers & Binnington
Toronto, Canada

Stephen O. Lockyer
President, Cornwallis Financial Corporation
Halifax, Canada

Peter Tolnai*
President, Orchard Capital Group Inc.
Toronto, Canada

Tom Woods
Managing Director,
CIBC Wood Gundy Securities Inc.
Toronto, Canada

Officers

Gregory Galanos
President & Chief Technology Officer
Cupertino, California

Jean Bélanger
Chairman & Chief Executive Officer
Austin, Texas

David Perkins
Senior VP, Sales & Business Development
Austin, Texas

Berardino Baratta
VP, Research & Development
Austin, Texas

John Cheuck
President, Metrowerks Co. Ltd.
Tokyo, Japan

Dave Mark
VP, Discover/Academic Products
Washington, DC

James Walker
Vice President, Operations
Austin, Texas

Jim Welch
VP, Finance & Chief Financial Officer
Austin, Texas

* appointed August 21, 1997

Stock Exchange Listings

Metrowerks Inc. shares are traded publicly
on the NASDAQ Stock Market and the Toronto
and Montreal Stock Exchanges.

Trading Symbols

MTWKF (NASDAQ), MWK (TSE, ME)

Solicitors

Tory Tory DesLauriers & Binnington
Toronto, Canada

Fenwick & West LLP
Palo Alto, California

Clark, Thomas & Winters
Austin, Texas

Auditors

Coopers & Lybrand LLP
Austin, Texas

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